Hotel Projects

Financing with Tax-Exempt Bonds

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DISCLAIMER: Nothing contained in this booklet should be construed or relied upon as legal advice. Instead, this booklet is intended to serve as an introduction to the general subject of the use of tax-exempt financing for hotel projects, from which better informed requests for advice, legal and financial, can be formulated.

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CHAPTER ONE

Introduction

Tax-exempt bonds are generally the least expensive form of project financing and often require less equity to be contributed to a project than traditional sources of financing. Investors in tax-exempt bonds will accept a lower rate of interest because the interest received is exempt from federal income tax (and usually the income tax of the state in which the bonds are issued). Until recently, however, tax-exempt financing was rarely considered as an alternative for financing hotel projects.

Hotels have traditionally been owned by private entities, and in general, private entities cannot get the benefit of tax-exempt financing, except for a limited category of projects that have been specifically permitted by Congress. In 1986, Congress eliminated from the list of eligible tax-exempt projects the two major categories that had previously been used for hotel financings—hotels for airports and other port facilities and exempt small issues for commercial purposes (which could only be used for relatively small projects under $10 million). The elimination of these project categories from the permitted list seemed to put an end to tax-exempt hotel financing.

However, due to the tightening of traditional finance sources for hotel projects, it has become more difficult for private hotel developers (“Developers”) to finance hotel projects. As a result, those Developers willing to work with state and local governmental entities (“Local Agencies”) have re-examined the federal tax law and found that, by working together and recasting the ownership structure, it is possible to use tax-exempt financing for hotel projects. While the amount of cooperation required of a Local Agency can be quite limited, we have generally seen tax-exempt hotel financings that are related in some fashion to public facilities such as a

convention center, airport or similar facility that would be enhanced by a hotel. These circumstances result in a confluence of interests between the Local Agency that wants a hotel project to be developed and the Developer that may be having difficulty financing it by conventional means.

Under federal tax law, bonds for a hotel project can only be tax-exempt if the project is *owned* by a Local Agency or a qualified nonprofit corporation ("Hotel Owner"). The Developer, therefore, must gain its financial advantage by other means, such as development fees, construction management fees and/or asset management fees. The Developer may in some cases have an option to purchase the hotel after the bonds have been paid, but only at the market price at that time. In addition, all contracts with Developers, construction firms, hotel operators, property managers and investors in a tax-exempt financed hotel must be carefully designed to comply with the federal tax law. In exchange for complying with these requirements, the benefits of tax-exempt financing can be realized.

The purpose of this booklet is to provide Local Agencies and Developers with relevant information about eligibility for, benefits of and procedures associated with tax-exempt financing of hotel projects.

The authors are members of the Public Finance, Tax and Real Estate Departments of Orrick, Herrington & Sutcliffe LLP, and each works regularly on tax-exempt financings of hotel projects. Orrick is the nation's leading tax-exempt bond counsel firm, ranked number one nationally for more than a decade,[1] with extensive experience in hotel financings.

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[1] Ranking of securities transactions of various types are performed annually by Securities Data Company, which has ranked Orrick number one in the country as bond counsel for tax-exempt bonds since prior to 1990. Orrick handles, on average, more than 300 bond issues aggregating more than $16 billion a year.

CHAPTER TWO

Why Use Tax-Exempt Bonds?

A. Options

Developers have the following choices for financing hotel projects:

- Conventional institutional lender or private investor financing, which usually requires substantial equity from the Developer;
- Conventional institutional lender or private investor financing, with a substantial financial contribution in the form of land, infrastructure or cash from a Local Agency (which may, in turn, reduce the equity otherwise required from the Developer); or
- Tax-exempt financing.

B. Advantages of Tax-Exempt Financing

Tax-exempt financing for hotel projects offers the following advantages:

- The principal advantage of tax-exempt financing is that it taps into the tax-exempt capital markets, an entirely different source of funds from traditional sources for financing hotel projects. In addition, investors in the tax-exempt market are familiar with and accepting of long-term nonrecourse project financing that combines both construction and long-term financing, often on more favorable terms than is typical of other sources of financing.

- Tax-exempt bonds represent the lowest cost of financing available for hotel projects. Generally, tax-exempt bonds are long-term (30 years or more), bear a fixed interest rate 2 to 4 percentage points lower than conventional financing rates because (1) such bonds are sold in the capital markets and (2) the exemption of interest from federal income tax (and usually income tax of the state in which the bonds are issued) produces the same after-tax return to the investor with less interest. For example, interest rates for 30-year tax-exempt bonds sold on or about September 1, 2001 were 5.3% for "BBB" rated bonds, compared to 7.5% for comparably rated taxable bonds[2] and 9% to 9.5% for conventional financing (which typically offers only a 10-year term instead of 30). Tax-exempt bonds can also be structured with variable interest rates.
- Tax-exempt financing is usually a better and cheaper option for the Local Agency than making substantial financial contributions, in cash or in kind, to a Developer to enable it to develop the hotel.
- The Developer is not required to contribute any equity, although the Developer may be required to put a portion of its fees at risk and/or to purchase subordinate lien bonds.
- Tax-exempt financing may be the only practical option. At the time this booklet was published, conventional financing was very difficult to obtain for major hotel projects.

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[2] Ratings refer to independent appraisals performed by one or more of the credit rating agencies of the credit quality of the bonds and the likelihood of their repayment. The ratings of Standard & Poor's Ratings Services, Moody's Investors Service or Fitch, Inc. are expressed as letter grades (AAA, AA, A, BBB from S&P and Fitch and Aaa, Aa, A and Baa from Moody's) from highest to lowest investment grade ratings, with +/- or numerical subcategories. Ratings are considered very important by the underwriters in marketing the bonds and by investors in determining what interest rates will induce them to purchase the bonds. Tax-exempt bonds may be sold with or without a rating.

C. Disadvantages of Tax-Exempt Financing

Tax-exempt financing for hotel projects has the following disadvantages:

- The principal disadvantage of tax-exempt financing for the Developer is that it is only available if the hotel is owned by a Local Agency or a qualified nonprofit corporation. Therefore, the Developer loses the benefits of ownership of the hotel (such as tax depreciation and potential appreciation in the value of the property). However, the Developer may receive certain fees (for example development fees, construction management fees and ongoing asset management fees) and may have an option to purchase the hotel when the bonds are paid off.

- The principal disadvantage of tax-exempt financing for the Local Agency may be public criticism about it unfairly competing with privately owned hotels within its jurisdiction.

- Federal tax law requirements related to tax-exempt bonds limit incentive based compensation in any contract between the Hotel Owner and a private hotel operator ("Hotel Operator").[3] See Chapter 6, "Financing Documentation – Qualified Management Agreements."

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[3] While federal tax law requirements limit the type of management arrangements with Hotel Operators, many Hotel Operators view management, versus ownership, as attractive. According to a ratings report issued by Standard & Poor's in 2001 on the Four Seasons Hotels Inc., "Standard & Poor's views hotel management as a less-risky way to participate in the lodging industry, compared to owning and developing hotel operations. Hotel management is a high margin and low capital-intensive business that generates relatively stable cash flow in excess of operating needs."

CHAPTER THREE

Unique Credit Considerations

A. Nonrecourse Financing

Tax-exempt bonds issued to finance hotel projects are typically structured on a nonrecourse basis. In other words, the bonds are limited obligations payable only from hotel revenues and any other specifically pledged revenues and assets,[4] and not from any other source of funds of the Local Agency. Nonrecourse financing is always challenging, particularly when based on the credit of a "to-be-built" hotel with no operating history and no equity contribution. Fortunately, the tax-exempt market is familiar and comfortable with nonrecourse financings. However, it is necessary that the participants structure the hotel financing to address in advance investor concerns about the risks they are being asked to undertake.

B. Construction Risk

Since these financings generally are structured on a nonrecourse basis as described above, the likelihood that investors will be repaid is dependent on construction of the hotel being completed on time and within budget. While tax-exempt investors are generally well versed in the credit analysis of construction contracts, it is essential to the success of the proposed financing that a qualified construction contractor ("General Contractor") be engaged.

As described in Chapter 6, "Financing Documentation," the General Contractor will normally be required to: (1) provide a guaranteed maximum price construction contract; (2) agree to complete construction by a specific date; and (3) pay liquidated

[4] Investors usually require that the bonds be secured by a deed of trust or mortgage on the hotel site, the hotel structure and all furniture, fixtures and equipment, if allowed under applicable state law.

damages in an amount at least equal to debt service accruing on the bonds should completion of the hotel be delayed beyond the agreed date. Other terms of the construction contract, including handling of change orders and *force majeure* events (acts of God), will be relevant to allocation of construction risk. The General Contractor will have to demonstrate its experience, financial strength and ability to fulfill its obligations under the contract or provide for third-party support in the form of a surety bond or other security.

C. Development and Operation Risk

The composition of the development and management team for the hotel project will be another critical credit component. Since the bonds will be payable solely from hotel revenues and other specifically pledged revenues and assets, investors must be confident that the team has the ability to: (1) manage the development of the hotel; (2) complete construction of the hotel based on a date-certain guaranteed maximum price construction contract; (3) market and maximize usage of the hotel on a start-up and on a long-term basis; and (4) successfully operate the hotel. See Chapter 5, "Principal Parties" for a description of the principal parties of a typical development and management team.

Another investor concern is that, while the private sector is responsible for producing hotel revenues, it is not compensated based upon performance of hotel operations because of the limitations imposed by federal tax law on agreements with a Hotel Operator. See Chapter 6, "Financing Documentation – Qualified Management Agreements." Investors may therefore be concerned that the Hotel Operator will not be sufficiently incentivized to ensure that the hotel's financial performance is optimal. This concern can be addressed to some extent by making a portion of the Hotel Operator's management fees subordinate to debt service on the bonds, although tax limitations require that it be reasonably expected that the Hotel Operator actually will receive the subordinate component of its compensation. In addition, the Hotel Operator may be allowed limited incentives.

D. Revenue Risk

Investors will also focus on factors affecting the stream of hotel revenues including:

- the location of the hotel;
- the local economy;
- the demand and competition (including hotel occupancy rates and room demand in the area); and
- projected revenues and expenses.

Because of the inherent uncertainty of revenue and expense projections of a "to-be-built" hotel, investors will demand that projected operating revenues, less projected operating expenses, substantially exceed debt service payments in each year that the bonds will be outstanding (often referred to as "debt service coverage"). For example, for every $1.00 of debt service on senior lien bonds, investors may require at least $2.00 of expected operating revenues after operating expenses. In order to address these issues, investors will often require a feasibility report. See Chapter 5, "Principal Parties – Financing Team – Feasibility Consultant" for a discussion of project feasibility reports.

E. Financing Structure

In order to address the concerns of investors detailed in this Chapter, a typical financing structure has involved the issuance of both senior lien bonds and subordinate lien bonds.[5] While there are many variations on how senior and subordinate lien financings may be structured, senior lien bonds generally have a first call on hotel revenues after expenses for payment of debt service and subordinate lien bonds will be paid only if amounts are then available thereafter.

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[5] Several recent financings have been structured with three series of bonds, each with a different level of priority on the hotel revenues and other pledged revenues and assets. These bonds are typically referred to as first tier bonds, second tier bonds and third tier bonds or as senior lien bonds, mezzanine lien bonds and subordinate lien bonds.

See Chapter 6, “Financing Documentation” for a sample chart of the uses of and priorities for hotel revenues.

Senior lien bonds usually have a final maturity of 30 or more years, with no principal payments scheduled until after completion of construction and an initial operating period. Debt service payments on senior lien bonds typically increase steadily until forecasted project stabilization and level off thereafter. Subordinate lien bonds are usually structured as capital appreciation bonds (i.e., a bond on which interest is not payable until maturity or earlier prepayment, but on which interest compounds periodically to accumulate to a stated maturity amount, like a zero-coupon bond).

Historically, subordinate lien bonds have been issued in a principal amount equal to 5-10% of the total hotel project financing requirements. However, in several recent transactions, the amount of the subordinate lien bonds issued has been greater than the amount of the senior lien bonds. This has facilitated the issuer’s ability to obtain bond insurance on the senior lien bonds, thus improving the marketability and price. The specific proportion of senior to subordinate lien bonds will be transaction specific and will depend upon, among other things, (1) the willingness of the project participants to participate as long-term investors in the subordinate lien bonds and (2) the amount necessary to meet the required debt service coverage levels on the senior lien bonds.

F. Accountability; Increased Coverage

A financing team must guard against investors perceiving that “no one is accountable” (because neither the public nor private sector has equity at risk) and that the hotel is being entirely “financed with other people’s money.” In order to successfully market the senior lien bonds, subordinate lien bonds and/or revenues in addition to hotel revenues may be needed to increase the levels of debt service coverage on the senior lien bonds desired by investors.

Often investors’ perceptions that no one in the private sector is at risk can be alleviated by the purchase of subordinate lien bonds by the Developer, the Asset

Manager (as defined below in Chapter 5, "Principal Parties – Development and Management Team"), the General Contractor and/or the Hotel Operator. Because subordinate lien bonds are paid after the senior lien bonds, the investors may consider the subordinate lien bonds economically to be a kind of "quasi-equity." It should be noted though, that the subordinate lien bonds must not be structured so they are treated as equity for tax or accounting purposes; that is, it must be reasonably expected that the subordinate lien bonds will be paid on a timely basis. Since the project participants are most familiar with the risks specific to the project, they are the most suitable parties to purchase subordinate lien bonds. Purchasers of subordinate lien bonds (1) are "co-investing" with bond investors and committing to the long-term success of the hotel and (2) provide a method to reduce the amount of senior lien bonds that must be sold and thereby reach the required debt service coverage level on senior lien bonds, enhancing their marketability.

In addition, a portion of the fees paid to the Hotel Operator or the Asset Manager may be subordinated to payment of debt service on the bonds and the Hotel Operator may provide a working capital loan or line of credit. Like any subordinate lien bonds, tax law requires that the participants reasonably expect that any such subordinated fees and other obligations will be paid as they become due (so that they not be considered to be equity for tax or accounting purposes).

To alleviate concerns that the public sector is not "at risk," investors in several (but not all) recently completed tax-exempt hotel financings have required limited financial commitments from the Local Agency. Several recent transactions have included an agreement by the Local Agency, subject to annual appropriation, to replenish any withdrawals from the debt service reserve fund established for the bonds (see Chapter 4, "Eligible Uses of Tax-Exempt Financing – Debt Service Reserve Fund") from hotel occupancy taxes levied by the Local Agency. In other transactions, the Local Agency has added a parking garage or other revenue-producing facility to the program in order to enhance security and cash flow. See Chapter 8, "Case Studies" for descriptions of the contributions made by Local Agencies in certain recent tax-exempt financings for hotel projects.

CHAPTER FOUR

Eligible Uses of Tax-Exempt Financing

A. Project Costs

The proceeds of tax-exempt bonds may be used to finance the cost of land acquisition, design, demolition, site work, buildings, furniture, fixtures and equipment and/or related infrastructure for hotel projects, which may include the hotel rooms and guest registration area, convention and conference room space, restaurants, cocktail lounges, health spas, gift shops, parking and other facilities.

The principal limitation on the types of hotel project assets that can be financed on a tax-exempt basis is that they must be owned by a Local Agency or nonprofit corporation that is an eligible Hotel Owner (see Chapter 5, "Principal Parties – Financing Team – Hotel Owner").[6] Secondly, even though such assets are owned by a Local Agency or nonprofit corporation, they may not be used in the trade or business of another person or entity that is not an eligible Local Agency or nonprofit corporation (a "nonexempt entity").

Nevertheless, the project or certain portions of it can be used by a nonexempt entity in its private trade or business (including nonexempt entities such as Hotel Operators, Asset Managers and restaurant, gift shop or other property managers) if:

- Financing of the portion of the project so used can be allocated to sources other

[6] There is also a limited category of tax-exempt financings in which the hotel is permitted to be privately owned, but only if the project is located in an "empowerment zone," as defined in federal law. A discussion of "empowerment zone" financings is beyond the scope of this booklet.

than proceeds of tax-exempt bonds (such as the proceeds of taxable debt or Local Agency contribution);

- The portion of the project so used represents less than 10% of proceeds of the tax-exempt bonds (net of bond proceeds used to fund a debt service reserve fund established for the bonds) or less than 5% if a 501(c)(3) nonprofit corporation is the Hotel Owner. (Where a 501(c)(3) nonprofit corporation is the Hotel Owner, the 5% is reduced by any proceeds used to pay costs of issuance of the bonds.); or

- The use by a nonexempt entity is pursuant to an operating or management contract that meets the requirements of I.R.S. Revenue Procedure 97-13. See Chapter 6, "Financing Documentation – Qualified Management Agreements" for a description of these requirements.

B. Working Capital

Working capital in an amount not exceeding 5% of the bond proceeds (net of bond proceeds used to fund a debt service reserve fund established for the bonds) can be included in a tax-exempt hotel financing in certain circumstances. Working capital may only be financed on a tax-exempt basis if it is directly related to the property financed with the bonds. In addition, working capital cannot be financed if a 63-20 corporation is used for issuing the debt. See Chapter 5, "Principal Parties – Financing Team – Issuer" for a description of a 63-20 issuer. Additional working capital may be obtained through a loan or line of credit from the Hotel Operator and/or from any hotel revenues in excess of operating expenses, debt service payments and other required reserves.

C. Capitalized Interest

Tax-exempt bonds issued for hotel projects typically involve both construction and long-term financing. Interest payable on the bonds during the longer of (a) three years or (b) the period during which the project is to be under construction plus up

to one year after completion of construction may be financed (i.e., capitalized) as part of the bond issue. The funded interest is held by the bond trustee and used to pay interest on the bonds during the expected period of construction and an initial operating period since there will be no hotel revenues available to pay debt service on the bonds until construction is completed and the hotel is generating revenue.

D. Debt Service Reserve Fund

It is common to have a debt service reserve fund held by the bond trustee and funded with bond proceeds equal to the least of (a) 10% of the bond issue, (b) 125% of average annual debt service on the bonds, or (c) maximum annual debt service (the most common measure). The debt service reserve fund is used to pay debt service on the bonds if for any reason the hotel revenues and any other funds pledged to payment of the bonds are not sufficient. If there is a draw on the debt service reserve fund to pay debt service on the bonds, the amount withdrawn is required to be restored with hotel revenues (or such other funds) in excess of operating expenses and debt service payments. There will be separate debt service reserve funds for the senior lien bonds and the subordinate lien bonds. Replenishment of amounts withdrawn from the debt service reserve fund for the senior lien bonds from net hotel revenues is senior in priority to the replenishment of the debt service reserve fund for the subordinate lien bonds.

E. Costs of Issuance

Costs incurred in connection with issuing the bonds, such as underwriter's discount or fees, fees of bond counsel and other lawyers and consultants providing services in connection with the financing, rating agency fees, trustee fees and the like, may be financed with proceeds of the bond issue. If a 501(c)(3) nonprofit corporation is the Hotel Owner, the amount of the bond proceeds that can be used for costs of issuance is subject to a cap of 2% of the bond issue. [7]

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[7] The costs of issuance cap does not include the cost of any bond insurance or credit enhancement, the cost of which can also be financed.

CHAPTER FIVE

Principal Parties

A. Development and Management Team

A typical development and management team would include: (1) the Developer, who contracts with the Hotel Owner to oversee development of the hotel; (2) the Architect, who contracts with the Hotel Owner, the Developer or the General Contractor to design the hotel; (3) the General Contractor, who contracts with the Hotel Owner or the Developer to build the hotel pursuant to a guaranteed maximum price construction contract; (4) the Construction Monitor, who acts on behalf of the Hotel Owner and the investors to insure that the hotel is built to specifications; (5) the Asset Manager, who acts on behalf of the Hotel Owner and the investors to manage the property following construction; and (6) the Hotel Operator, who contracts with the Hotel Owner or the Developer to operate the hotel.

Developer. While a Local Agency may itself develop a hotel or work directly with a flag hotel operator as a Developer, most transactions done to date have had a private hotel developer with a credible record for developing projects of similar kind and size. Sometimes the project originates with a Local Agency that has a site it wants to have developed as a hotel (perhaps to support a convention center, airport or sports facility). The Local Agency may select a developer by Request For Proposals ("RFP") or similar process. In other cases, a private developer may have a hotel project it is seeking to develop. In either case, if the Developer is unable to obtain conventional financing on acceptable terms, it turns to the Local Agency for assistance.

The Developer is typically responsible for supervising the overall development of the hotel, including assisting in selecting the General Contractor for construction of

the hotel and selecting the Hotel Operator for operation of the hotel. Developers often assist in the local environmental and permitting processes to insure that the project is ready to be financed. The Developer will also negotiate with the General Contractor, the Hotel Operator and the Hotel Owner with respect to development, construction and operation of the hotel. The Developer will receive a "development fee" as consideration for its work in the development of the hotel. See Chapter 6, "Financing Documentation" for a description of the Development Management Agreement between the Hotel Owner and the Developer relating to such services.

In certain cases, the Developer, instead of the Hotel Owner, will contract directly with the General Contractor and/or the Hotel Operator. In addition, the Developer may also serve other roles in the development and management team, for example, as Asset Manager. Fees paid to the Developer may include: development fees, construction management fees and ongoing asset management fees, provided the Developer plays these roles and provides these services. The Developer may also have an option to buy the hotel after maturity of the bonds so long as that option is not treated as an ownership interest for tax purposes, meaning that the option price must represent the fair market value at the time the option is entered into (normally at or before the bonds are issued) to result in market price at the time the option is exercised.

Architect. The architect (the "Architect") will design and provide other services with regard to planning, permitting and constructing the hotel. The fees for the Architect's services will generally be payable by the Hotel Owner. Such expenses can also be included in the guaranteed maximum price under the Construction Contract if the hotel is being constructed on a design-build basis or under the Development Management Agreement if the Developer is obligated to construct the hotel.

General Contractor. The General Contractor is typically responsible for demolition, site work and construction of the hotel. The General Contractor should be nationally or regionally recognized in large commercial construction projects and should be a creditworthy entity. The General Contractor may contract with the Hotel Owner, or in certain cases, with the Developer. See Chapter 6, "Financing Documentation" for a description of the Construction Contract.

Construction Monitor. A construction monitor ("Construction Monitor") that is independent of the General Contractor may be required in some financings to act on behalf of the investors to monitor and report on the construction of the hotel. The Construction Monitor's responsibilities will typically involve: (1) inspecting, on a monthly basis, the actual progress of the construction of the hotel project and performing a comparison of the actual progress of the construction with the planned construction schedule, and (2) inspecting, on a monthly basis, the actual construction expenditures and performing a comparison of the planned construction budget with the actual construction expenditures.

Asset Manager. There is often, and investors may require, an asset manager that is independent of the Hotel Operator ("Asset Manager") to monitor operation of the hotel and oversee the activity of the Hotel Operator on behalf of the Hotel Owner once the hotel is operational. In the tax-exempt structure, it is prudent to have an Asset Manager if, as is often the case, the Hotel Owner is not experienced in the hospitality business. As discussed above, in some cases the Developer (or an entity related to the Developer) has also acted as the Asset Manager. The Asset Manager will receive an "asset management fee" in consideration of its oversight of hotel operation. See Chapter 6, "Financing Documentation" for a description of the Asset Management Agreement.

Hotel Operator. The Hotel Operator is a private company in the business of operating hotels under a recognized flag name. The Hotel Operator is responsible for overall operation of the hotel, including providing and training employees, providing reservation services and maintaining and promoting the hotel. See Chapter 6, "Financing Documentation" for a description of the Hotel Operating Agreement.

B. Financing Team

The typical financing team would include: (1) the Issuer, who issues the bonds; (2) the Hotel Owner, who owns the hotel; (3) Bond Counsel, who acts as counsel to the Issuer and is responsible for opining on the validity and tax exemption of

the bonds; (4) the Feasibility Consultant, who prepares a report addressing the feasibility of the hotel project; and (5) the Underwriter, who is responsible for marketing the bonds.

Issuer. Generally, with the singular exception cited in the next paragraph, only state or local governmental entities are eligible to issue tax-exempt bonds ("Issuer"). In the usual case, the Hotel Owner borrows the proceeds of tax-exempt bonds issued by such an Issuer under a Loan Agreement. The Issuer must have the power under the law of the state in which it is located to issue bonds to finance hotel projects. The Issuer will have no liability whatsoever to pay any principal or interest on the bonds except from payments received from the Hotel Owner pursuant to the Loan Agreement and from any other specifically pledged revenues and assets. Although unusual, in certain circumstances the Issuer can be the Hotel Owner. (See Chapter 6 for a more complete description of the structure of a tax-exempt hotel financing.)

A so-called "63-20 corporation," which is a nonprofit corporation considered to be acting on behalf of a Local Agency in accordance with the requirements of I.R.S. Revenue Ruling 63-20 (as updated by Revenue Procedure 82-26) may also act as an Issuer. However, bonds issued by a 63-20 corporation may not, under federal tax law, be used to finance any working capital and may not be exempt from state income tax in some states. In addition, unencumbered title to the hotel project must vest in the Local Agency at the end of the term of the bonds.

Hotel Owner. Federal tax law requires that the Hotel Owner be:

- a governmental entity, such as the Local Agency;
- a nonprofit corporation established as an "instrumentality" of the Local Agency described in Section 115 of the Internal Revenue Code; or
- a nonprofit corporation described in Section 501(c)(3) of the Internal Revenue Code (commonly referred to as a "501(c)(3) corporation").

In almost all cases, it will be preferred that a nonprofit corporation be created to act as Hotel Owner. The Local Agency may not have the power under state law to own a hotel. The Local Agency also may prefer to use a nonprofit corporation as

the Hotel Owner to stay at arm's-length from the bonds and from the potential liabilities of hotel ownership. A nonprofit corporation also may not be subject to the complex procurement procedures typically applicable to Local Agencies, such as competitive bidding, set asides, prevailing wage and other similar requirements.

If the Local Agency determines that a nonprofit corporation should act as Hotel Owner, it must choose between an "instrumentality" of the Local Agency as described in I.R.S. Revenue Ruling 57-128 and a 501(c)(3) corporation. An "instrumentality" nonprofit corporation requires a good deal more control by the Local Agency than is the case in most 501(c)(3) corporations, including, for example, the power to appoint and remove directors and to approve the corporation's budgets. In some jurisdictions, these connections may be considered too close to the Local Agency to avoid agency liability or competitive bidding or similar requirements.

A 501(c)(3) corporation is a nonprofit corporation that has received a determination letter from the I.R.S. that it qualifies as an organization of the type described in Section 501(c)(3) of the Internal Revenue Code. In order for a nonprofit corporation to be eligible for 501(c)(3) status in this context, it must be determined to "lessen the burdens of government." [8] Local Agency involvement in the 501(c)(3) corporation can range from nearly as much as in the "instrumentality" nonprofit to virtually total separation and little if any direct involvement. Receipt of a 501(c)(3) determination letter from the I.R.S. is not guaranteed and can take up to four or five months. Moreover, if a 501(c)(3) corporation is used as Hotel Owner, federal tax law imposes additional requirements that are not present with non-501(c)(3) owner-ship, such as (a) requiring financing and project approval by the

[8] If a nonprofit corporation performs commercial activities that are traditionally conducted by for-profit corporations, where those activities are recognized as a burden of government, a nonprofit that undertakes the activity may qualify for 501(c)(3) status because "lessening the burdens of government" is considered a charitable purpose. Obtaining a 501(c)(3) determination for such a corporation usually requires counsel experienced in showing (1) historic governmental involvement in the type of activity to be undertaken by the corporation and (2) the various kinds of relationships between the corporation and the government whose burden is to be lessened that the I.R.S. will find relevant. The application to the I.R.S. for 501(c)(3) status will normally include a letter of support from the Local Agency to evidence the lessening of its governmental burdens.

elected officials in the jurisdiction in which the hotel is located (in most cases, this will be the Local Agency) after a noticed public hearing, and (b) limiting bond proceeds used to pay the cost of issuing the bonds to 2% of the amount of the bonds. See Chapter 4, "Eligible Uses of Tax-Exempt Financing – Costs of Issuance."

A single nonprofit corporation that has been structured to satisfy the requirements of a "63-20 corporation" and an "instrumentality" under Section 115 of the Internal Revenue Code may act as Issuer and Hotel Owner. However, because of the limitations on borrowing for working capital discussed above and other restrictions specific to 63-20 corporations, it is more common to have a governmental entity act as Issuer.

Bond Counsel. Bond Counsel is the law firm primarily responsible for rendering a legal opinion on the validity and tax exemption of the bonds and for drafting the legal documents to be executed by the Hotel Owner and the Issuer in connection with the bond issue (and in some cases for creating the Hotel Owner and obtaining the necessary 501(c)(3) determination). In addition, Bond Counsel's responsibilities may include drafting the project documents, including the Development Management Agreement, the Asset Management Agreement and the Hotel Operating Agreement. Bond Counsel typically represents the Issuer, and the Hotel Owner is represented by its own counsel (although such counsel may not be engaged until after the corporation is organized and receives its 501(c)(3) determination, which may be handled by Bond Counsel). The tax-exempt capital market expects opinions of Bond Counsel to come from a nationally recognized law firm expert in such matters. Hotel financings can be very complicated and in most cases the transactions will run more smoothly with Bond Counsel experienced in similar hotel tax-exempt bond financings and, given the tax driven nature of such financings, particularly experienced in the complex tax laws that govern the tax exemption of such bonds.

Feasibility Consultant. A financial feasibility report is usually a necessary first step in formulating a plan of finance. For the reasons covered under Chapter 3, "Unique Credit Considerations – Revenue Risk," it is often necessary to have a feasibility report by a nationally recognized expert in the hospitality industry in order to market the bonds successfully. The prospective hotel operation must be based on economic realities that can be supported by a feasibility report quantifying the projected

demand for the hotel, given the market and the economy in which it is to be located.

Generally, financial feasibility reports address the following issues:

- Market demand for the proposed hotel considering location, size of the proposed hotel and market and competitive factors;
- Projected pledged revenues with particular focus on the magnitude and stability of such revenues; and
- Reasonableness of operating assumptions, including pricing and budget information.

Underwriter. The Underwriter is an investment banking firm that is responsible for marketing the bonds in the tax-exempt capital market. The Underwriter will help to structure the financing, help to organize the project financial information for inclusion in the Official Statement and for presentation to the rating agencies to obtain ratings on the bonds and/or to bond insurers or credit providers, and purchase (i.e., underwrite) the bonds for resale to investors. Counsel to the Underwriter is usually primarily responsible for preparing the Bond Purchase Contract and the Official Statement. (See Chapter 6, "Financing Documentation – Financing Documents – Bond Purchase Contract and Official Statement.") Given the specialized nature of hotel securities, Underwriter's Counsel should be very experienced in hotel financings and in the disclosure requirements for such financings.

Additional Legal Counsel. Various members of the development and management team as well as other participants of the financing team may have in-house or independent counsel representing each of their respective interests during the financing. Typically, lawyers representing the Developer, the General Contractor, the Asset Manager, the Hotel Operator, the Issuer, the Hotel Owner and even the bond trustee and bond insurer may also have some involvement in the formulation of financing structure and document review.

CHAPTER SIX

Financing Documentation

A. Financing Documents

Indenture. The bonds are issued by the Issuer under the provisions of an indenture or trust agreement (the "Indenture") – a lengthy contract entered into by the Issuer and an acceptable bank trustee (the "Trustee"). Bond Counsel takes responsibility for drafting the Indenture, many portions of which must follow the conventions of the tax-exempt market. The Indenture provides for the issuance and sets forth the terms of and the security for the bonds, establishes the funds and accounts held by the Trustee under the Indenture for the payment and security of the bonds and operation and maintenance of the hotel, and provides for the rights and obligations of the Issuer and the Trustee in the event of default. Senior lien bonds and subordinate lien bonds may be issued pursuant to a single Indenture. Under the Indenture, the Issuer pledges to the Trustee, for the benefit of the holders of the bonds, all of the rights of the Issuer under the Loan Agreement (including the Hotel Owner's pledge of hotel revenues thereunder) and any other security documents, such as a deed of trust, mortgage or security agreement. The Trustee will receive all hotel revenues and other specifically pledged revenues and deposit such amounts into designated accounts established and held by the Trustee in accordance with a priority of payment set out in the Indenture.

Set forth on the following page is a chart showing typical priority of payment for the deposit of hotel revenues under an Indenture:

The Flow of Hotel Revenues

Under the Indenture, the Trustee will also hold the project fund moneys until requisitioned for payment of appropriate hotel project expenses. It is common to require that all requisitions for the hotel project be approved by the Construction Monitor prior to release of funds held under the Indenture.

Loan Agreement. The proceeds of the bonds are loaned by the Issuer to the Hotel Owner pursuant to a loan agreement (the "Loan Agreement") between the Issuer and the Hotel Owner. Under the Loan Agreement, the Hotel Owner pledges the hotel revenues to the Issuer as security for the repayment of the loan. The Loan Agreement also contains covenants of the Hotel Owner relating to the hotel, including an agreement to maintain the hotel in good condition and maintain qualifying agreements with the Hotel Operator and Asset Manager while any of the bonds remain outstanding.

Deed of Trust/Mortgage. If allowed under applicable state law, the Hotel Owner will enter into a deed of trust or mortgage on the hotel site, the hotel structure and all furniture, fixtures and equipment for the benefit of the Trustee, on behalf of the holders of the bonds.

Local Agency Agreement. The bonds may be additionally secured by a limited financial commitment from the Local Agency. Several recent transactions have included the agreement of the Local Agency, sometimes subject to annual appropriation, to replenish any withdrawals from the debt service reserve fund established for the bonds from hotel occupancy taxes levied by the Local Agency.

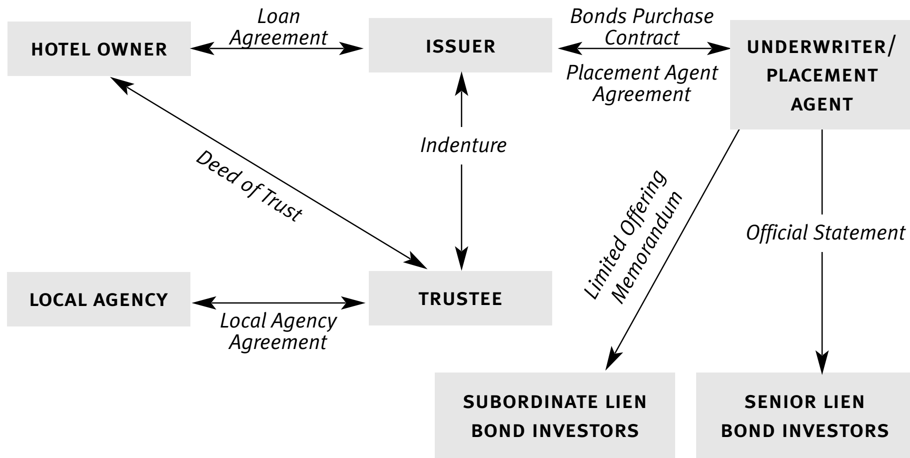
Bond Purchase Contract and Official Statement. The senior lien bonds are sold by the Issuer to an Underwriter pursuant to a bond purchase contract (the "Bond Purchase Contract") between the Issuer and the Underwriter and approved by the Hotel Owner, for resale to investors in the tax-exempt market. The Bond Purchase Contract obligates the Underwriter to purchase the senior lien bonds for a specified price on a specified closing date subject to the conditions, including representations, certifications and opinions, described in the Bond Purchase Contract. The sale by the Underwriter to potential investors depends on the use of an offering document (the "Official Statement") describing the senior lien bonds and relating all other information that investors would consider to be material in deciding whether to buy the bonds. An Official Statement is the Issuer's disclosure document although most of the material in it is prepared by financing team members or by the various development and management team members. Each party of the development and management team will be expected to provide information about relevant experience

and, in some cases, certain financial information for inclusion in the Official Statement. The report of the Feasibility Consultant is also normally included in the Official Statement. Several of the parties will be expected to certify (and their attorneys to provide legal opinions) that the information in the Official Statement meets the requirements of federal and state securities laws that such information be accurate and not omit anything necessary to make the statements contained therein, in light of the circumstances under which made, not misleading in any material respect.

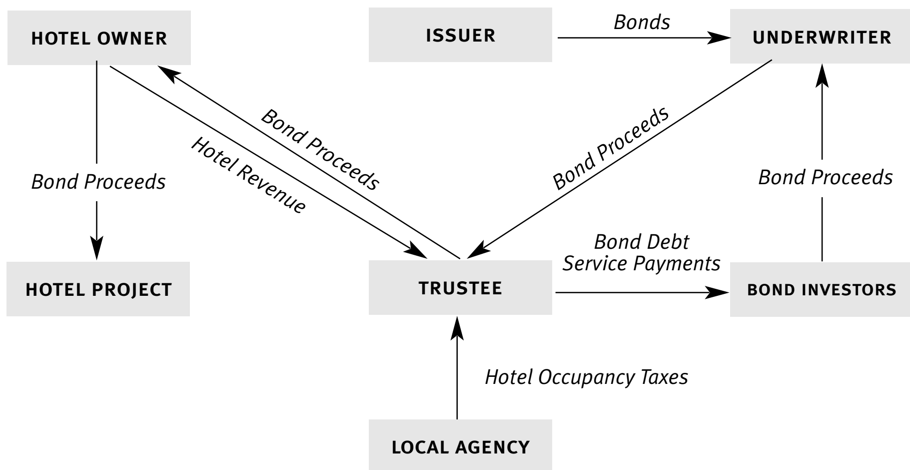
Placement Agent Agreement and Limited Offering Memorandum. The subordinate lien bonds are privately placed with development and management team members or other sophisticated investors pursuant to a placement agent agreement ("Placement Agent Agreement") between the Issuer and the Underwriter and approved by the Hotel Owner, acting for purposes of the subordinate lien bonds as placement agent. It is common for purchasers of subordinate lien bonds to be required to sign a sophisticated investor letter or so-called "big-boy" letter, meaning a letter containing representations as to the sophistication of the investor and acknowledging the risk of purchasing subordinate lien bonds, the receipt of relevant information and that the purchaser is buying the subordinate lien bonds for investment and not with a view to resale. Sometimes (usually depending on the policies of the Issuer) such private placements may also require that the subordinate lien bonds can be transferred or sold only to other sophisticated investors who sign a similar "big boy" letter. A limited offering memorandum ("Limited Offering Memorandum"), separate from the Official Statement and containing information material to investment in the subordinate lien bonds, may be used in connection with their sale to sophisticated investors. A Limited Offering Memorandum may not be necessary if the subordinate lien bonds are to be purchased by development and management team members willing to purchase subordinate lien bonds without a separate offering document.

Set forth on the facing page are charts of a typical financing structure and the associated money flow:

The Financing Documents



The Money Flow



B. Project Documents

Development Management Agreement. The Developer will enter into a Development Management Agreement with the Hotel Owner under which the Developer will be responsible for overseeing development of the hotel project. In some cases, the Developer is also responsible for completion of the hotel by a guaranteed completion date for a guaranteed maximum price, either directly or by supplying a third party surety covering liquidated damages in an amount at least equal to the daily interest accruing on the bonds if the hotel is not timely completed. The Developer may also enter into appropriate contracts with an Architect and a General Contractor, from whom it will obtain performance and payment guarantees in an amount equal to the guaranteed maximum price and some or all of the liquidated damages. If the Developer is not willing or able to take this risk, the Hotel Owner will contract with the General Contractor and rely on provisions in the Construction Contract to cover these risks.

Construction Contract. The Hotel Owner or the Developer will enter into a Construction Contract with the General Contractor under which the General Contractor will perform all demolition and site work and construct the hotel for a guaranteed maximum price.[9] The guaranteed maximum price will cover all costs required to complete the identified work under the Construction Contract. Preferably, the guaranteed maximum price contract should be based on final plans and specifications, and, if possible, completed working drawings in order to provide investors with confidence that there will be sufficient funds to complete construction of the hotel project. Most, if not all, of the *force majeure* risk may be allocated to the General Contractor. In addition to statutory warranties, the General Contractor typically provides an express warranty for all work done under the Construction Contract for a minimum period of one year following the substantial completion date.

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[9] Note that if the hotel is owned by the Local Agency, or in some cases by a corporation established as an instrumentality of the Local Agency, there may be a question about whether competitive bidding of construction contracts is required under state law. See Chapter 5, "Principal Parties – Financing Team – Hotel Owner."

The General Contractor will provide performance and payment guarantees in an amount equal to the guaranteed maximum price. Claims under the performance and payment guarantees may be made by the Hotel Owner, the Issuer or the Trustee acting on behalf of the bondholders to pay any costs incurred in completing any of the work under the Construction Contract or to pay the liquidated damages payable by the General Contractor.

The General Contractor will be obligated to pay liquidated damages for each day the completion date is delayed beyond the guaranteed completion deadline in an amount at least equal to daily interest accruing on the bonds (usually, interest on only the senior lien bonds is required). The obligation of the General Contractor to pay liquidated damages is secured by the performance and payment guarantees and may terminate if the work under the Construction Contract has been completed prior to the completion date.

Asset Management Agreement. If an Asset Manager is desired or required, the Hotel Owner and the Asset Manager will enter into an Asset Management Agreement pursuant to which the Asset Manager will be paid a fee to undertake asset management for the hotel, i.e., oversee hotel operations for the Hotel Owner and investors. By reason of credit considerations discussed in Chapter 3 above, a key component of any hotel financing may be to subordinate a portion of this fee to be paid after debt service on the senior lien bonds. Even though a portion of the fee may be subordinated, tax law requires that that all of the fee be reasonably expected to be timely paid. Other tax law requirements pertaining to the term and structure of the Asset Management Agreement are discussed below under subsection C of this Chapter 6. The Hotel Owner agrees under the Loan Agreement to maintain the Asset Management Agreement or a similar replacement agreement for as long as any bonds are outstanding. The Asset Management Agreement normally permits early termination upon the occurrence of certain events, including defaults by the Hotel Owner or the Asset Manager, substantial damage, destruction or condemnation of the hotel, the bankruptcy of the Asset Manager or, in some cases, the failure of the hotel to meet certain financial operating tests set forth in the Asset Management Agreement.

Hotel Operating Agreement. The Hotel Owner and the Hotel Operator will enter into a Hotel Operating Agreement pursuant to which the Hotel Operator will be paid a fee to operate and manage the hotel under a flag acceptable to the Hotel Owner.[10] The tax law rules discussed below in subsection C of this Chapter 6 govern the term and fee structure of the Hotel Operating Agreement and, among other things, prohibit any of such fee being based on net profits from hotel operations and limit other ways of establishing incentive based compensation. Therefore, like the Asset Manager's fee, a portion of the operating fee will usually be subordinated to payment of debt service on the senior lien bonds. The Hotel Operator will agree to operate the hotel to satisfy the specified performance standards and to maintain the hotel in good condition. The Hotel Operating Agreement normally permits early termination upon the occurrence of certain events, including defaults by the Hotel Owner or the Hotel Operator, substantial damage, destruction or condemnation of the hotel, the bankruptcy of the Hotel Operator or the failure of the Hotel Operator to operate the hotel in a manner which meets certain financial operating tests set forth in the Hotel Operating Agreement.

Pre-Opening Services Agreements. In addition to acting as Hotel Operator, it is customary for the Hotel Operator to also act as Pre-Opening Manager and provide the goods and services needed to open the hotel. The Pre-Opening Manager is required to provide certain services necessary before the hotel opens to the public, including marketing efforts which are generally scheduled to begin approximately eighteen months before opening, hiring and training staff prior to opening, acquisition of licenses and permits on behalf of the Hotel Owner and other services necessary to open the hotel in a timely manner. In addition, the Pre-Opening Manager will generally provide certain technical services, including the review of design and construction documents to assure that the hotel is being built in

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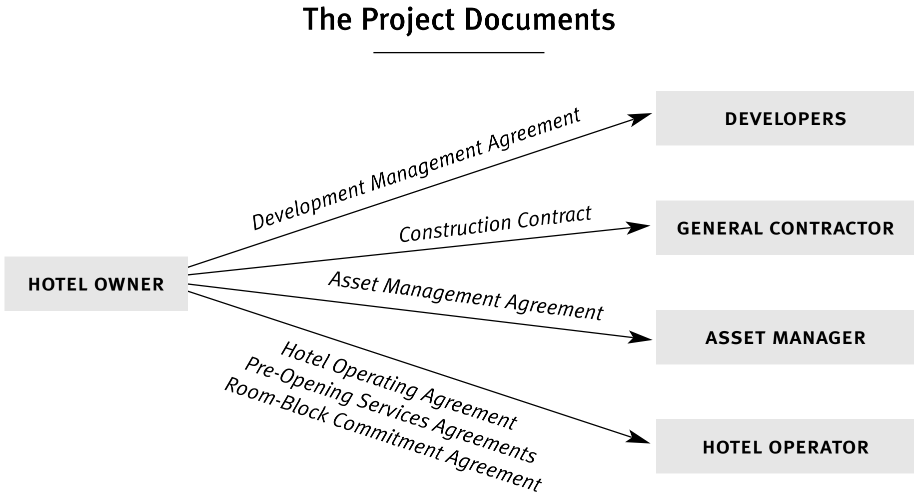
[10] In some financing structures, a single management agreement complying with federal tax law is entered into with the Developer, which then enters into an operating agreement with the Hotel Operator. The agreement between the Developer and the Hotel Operator would not be subject to the limitations of federal tax laws because all rights and income are derived from the agreement between the Hotel Owner and the Developer. This means that the Hotel Operator's fee may even be based on the Developer's net revenues because it is paid out of the qualified fee paid to the Developer under the management agreement. However, the more successful the hotel and the greater the Hotel Operator fee, the lower the remaining fee available to the Developer.

conformity with the Hotel Operator's brand standards. The Pre-Opening Manager will also assist the Hotel Owner in the commissioning and hand-over of the hotel. The Pre-Opening Manager is required to acquire, on behalf of the Hotel Owner, all the necessary information technology for the hotel and to manage its installation. This technology can include the hardware and software for the hotel telephone system, the computerized reservations system, office computer systems, safety and security systems and other necessary information technology.

Room-Block Commitment Agreement. The Hotel Owner and the Hotel Operator may enter into an agreement under which the Hotel Operator agrees to make a certain number of hotel rooms available to the Hotel Owner at reduced rates in order to facilitate use of an adjacent public facility such as a convention center.

Set forth below is a chart of the typical structure of the project documents:



C. Qualified Management Agreements

The management agreements with the Hotel Operator and the Asset Manager, as well as any other nonexempt entities using the hotel, must be structured as Qualified Management Agreements (each, a "QMA"), meaning that they need to meet the requirements of I.R.S. Revenue Procedure 97-13. In general, I.R.S. Revenue

Procedure 97-13 allows for two basic types of Qualified Management Agreements that are used for hotel financings:

15-Year Qualified Management Agreement

Term*:* Maximum term of 15 years (including any renewal options exercisable solely by the Hotel Operator or Asset Manager, as the case may be), although the term can be shorter.

Termination*:* No specific termination provisions are required.

Compensation*:* At least 95% [11] of the compensation paid to the Hotel Operator or Asset Manager, as applicable, must be based on a periodic fixed fee. A periodic fixed fee is a stated dollar amount for a specified period (but may be automatically escalated by an objective external standard not related to the performance of the hotel such as the Consumer Price Index). The fixed fee may be "bumped" with an incentive payment (either one time or for the remainder of the term) if certain performance standards are met (such as occupancy or gross revenue targets, but not net revenues) but the "bump" must be a fixed amount. Any other variable component of the compensation cannot exceed 5% of the total compensation in any year and may be based on operating factors but not net revenues.

5-Year Qualified Management Agreement

Term*:* Maximum term of 5 years (including any renewal options exercisable solely by the Hotel Operator or Asset Manager, as the case may be), although the term can be shorter. However, the contract can be structured on an "evergreen basis," with a new contract entered into by mutual consent every year. This arrangement can effectively result in a continual term of at least four years.

Termination*:* The Hotel Owner must have the ability at the end of the third year to terminate the contract without cause or penalty.

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[11] 80% if the contract term does not exceed 10 years.

Compensation: At least 50% of the compensation paid to the Hotel Operator or Asset Manager, as applicable, must be based on a periodic fixed fee, as described above for a 15-year QMA. The variable component cannot exceed 50% of the total compensation paid in any year and may be based on operating factors but not net revenues.

Under either type of QMA, actual reimbursement of costs paid to unrelated third parties may be passed through and paid from hotel revenues and need not be counted against the "compensation" under the Qualified Management Agreement. In addition, under either type of QMA, the total compensation must be reasonable for the services provided. Moreover, in order to prevent the Hotel Operator or the Asset Manager or any other nonexempt entity from having a relationship with the Hotel Owner that could substantially limit the Hotel Owner's ability to exercise its rights under the applicable QMA, the Hotel Operator, the Asset Manager or the private operator or manager cannot control (for example, appoint) more than 20% of the members of the board of the Hotel Owner and no board member of the Hotel Owner may be the chief executive officer of such private entity or its governing board (or vice versa).

In the usual case, the Hotel Operating Agreement is structured as a 15-year QMA because the Local Agency and the bond investors would like the Hotel Operator to operate the hotel for as long as possible.

CHAPTER SEVEN

Steps To Issuance

A. Steps

While there are many variations depending on the type, policies and procedures of the Issuer, applicable state law, the type of Hotel Owner and other factors, the following is illustrative of the basic steps in a typical tax-exempt bond issue for a hotel project:

1. ***Engage Bond Counsel.*** It is important that the Local Agency or the Developer engage Bond Counsel early in the process to determine whether the hotel project it wishes to finance is eligible for tax-exempt financing and to help design the basic legal and structural conditions for such a financing. It is important to have Bond Counsel experienced in tax-exempt hotel financings and, given the tax driven nature of such financings, particularly experienced in the complex tax laws that govern the tax exemption of interest on the bonds.

2. ***Engage the Underwriter.*** Consulting the Underwriter early is crucial to determining whether it will be possible to market bonds for the hotel project and, if so, what structural features may be required. Underwriters can also provide expertise as to what rating might be expected on the senior lien bonds, the amount of subordinate lien bonds and/or Local Agency security that may be required and ranges of likely interest rates which can be used in a preliminary feasibility analysis. Experienced Underwriters work out the basic structure of the financing with Bond Counsel and other key parties.

3. ***Engage the Feasibility Consultant.*** If not already commissioned, and Bond Counsel and/or the Underwriter advise that a feasibility report on the hotel

project will be necessary, the Developer or Hotel Owner should engage a nationally recognized feasibility consultant in the hospitality industry to prepare a feasibility report on the project. If a report is already available, the financing team should review it to determine the adequacy of the scope of the report and the reasonableness of the assumptions and conclusions.

4. ***Identify the Issuer.*** Determine with Bond Counsel and the Underwriter what public entity will serve as the Issuer of the bonds. See Chapter 5, "Principal Parties – Financing Team – Issuer." In some states and in selected situations, there may be several possible issuers with different policies, procedures, politics, governing laws and fees.

5. ***Identify the Hotel Owner.*** Determine with Bond Counsel, the Underwriter, the Developer and the Local Agency what entity will own the hotel. See Chapter 5, "Principal Parties – Financing Team – Hotel Owner." If a nonprofit corporation is chosen as the Hotel Owner, Bond Counsel (if so engaged for this purpose) will prepare the proposed articles of incorporation, bylaws and initial resolutions of the corporation and orchestrate the required filings with the Secretary of State. If a corporation acting as an instrumentality of the Local Agency is chosen as the Hotel Owner, the governing body of the Local Agency will have to adopt a resolution authorizing the creation of the corporation as an instrumentality. If the corporation is to be a 501(c)(3) corporation, Bond Counsel typically will prepare and submit a request to the I.R.S. for determination of 501(c)(3) status, and the Local Agency will only have to submit a letter of support of the application to the I.R.S. for 501(c)(3) status.

6. ***Develop a Structure for the Financing.*** Determine with Bond Counsel, the Underwriter and the Developer what structure is most likely to result in a successful marketing of the bonds to investors. In most cases, this will involve a senior series and a subordinate series of bonds. In addition, some contribution by the Local Agency may be required to raise the debt service coverage on the senior lien bonds to levels meeting market expectations.

7. ***Identify the Hotel Operator.*** Determine with the Underwriter, the Developer and the Local Agency what entity will operate the hotel. The Hotel Operator may be selected by the Developer, the Hotel Owner or the Local Agency, or a combination.

8. ***Identify the Asset Manager.*** In most cases, the Developer will act as the Asset Manager. If the Developer will not act as the Asset Manager, the Hotel Owner, in consultation with the Underwriter, should select a qualified Asset Manager.

9. ***Identify the General Contractor and the Design/Construction Process.*** The Local Agency and the Hotel Owner determine with the Underwriter and the Developer how the design and construction of the hotel project will be structured and whether the Developer or the Hotel Owner will be responsible for contracting with the Architect and/or General Contractor. State law may require that the construction contract is subject to competitive bidding laws and other requirements.

10. ***Prepare Financing and Project Documents.*** Bond Counsel prepares and circulates to the working group initial drafts of an Indenture and Loan Agreement (and a Deed of Trust/Mortgage and Local Agency Agreement, if applicable). If so engaged, Bond Counsel also prepares and circulates to the working group initial drafts of the Development Management Agreement, the Hotel Operating Agreement and the Asset Management Agreement (and the Pre-Opening Services Agreements and Room-Block Commitment Agreement, if applicable).

11. ***Prepare Offering Document.*** Underwriter's counsel prepares and circulates to the financing team initial drafts of a Bond Purchase Contract and Preliminary Official Statement for the senior lien bonds as well as a Placement Agent Agreement and Limited Offering Memorandum for the subordinate lien bonds.

12. ***Develop Documentation.*** The financing team conducts a series of meetings or conference calls to discuss the foregoing documents (including the feasibility report). Responsible parties circulate revised drafts.

13. ***Obtain Credit Ratings or Insurance.*** Draft documents are submitted for review and comment by the rating agencies and/or bond insurers or credit enhancement providers. Presentations are prepared by the Underwriter and made to the rating agencies and/or bond insurers by the Underwriter and the Developer.

14. ***Obtain 501(c)(3) Determination Letter.*** If applicable, the I.R.S. determination letter regarding 501(c)(3) status of the Hotel Owner should be received from the I.R.S. by this point in the process if not sooner.

15. ***Approve Project.*** The governing board of the Hotel Owner approves the bond issue and authorizes execution of the financing and project documents to which it is a party.

16. ***Authorize All Documents.*** The governing boards of the Developer, the General Contractor, the Hotel Operator, the Asset Manager (if not the Developer) each authorize execution of the financing and project documents to which it is a party.

17. ***Enter Into Construction Contract.*** The General Contractor and Hotel Owner (or Developer) enter into a suitable guaranteed maximum price construction contract, subject to the successful closing of the bonds.

18. ***Finalize Feasibility Report.*** The Feasibility Report is finalized and included in the Official Statement and the Limited Offering Memorandum.

19. ***Hold Public Hearing.*** If the Hotel Owner is a 501(c)(3) corporation, tax law requires that a hearing be held, prior to approval of the bonds, by the Local Agency (or a government entity in whose jurisdiction the hotel project is to be located, if not the Local Agency) after at least 14 days published notice.

20. ***Approve Issue.*** The governing board of the Issuer adopts the bond resolution authorizing issuance of the bonds, execution and delivery of the financing documents and distribution of the Official Statement and Limited Offering Memorandum.

21. ***Mail Offering Documents in Preliminary Form.*** The Underwriter mails the Preliminary Official Statement to potential purchasers of the senior lien bonds (and/or posts it on the internet and e-mails notice of its availability). The Underwriter, acting as a Placement Agent for the subordinate lien bonds, mails a Limited Offering Memorandum to potential purchasers of the subordinate lien bonds.

22. ***Price Bonds.*** The bonds are priced (i.e., setting the interest rates to be borne by the bonds) by the Underwriter or Placement Agent, as applicable (based on expressed interest by investors), in consultation with the Issuer and the Hotel Owner.

23. ***Sell Bonds.*** The senior lien bonds are sold by execution of the Bond Purchase Contract by the Issuer and the Underwriter and approval by the Hotel Owner. Subordinate lien bonds are privately placed with investors, including possibly the Developer, the General Contractor and the Hotel Operator, pursuant to the Private Placement Agreement executed by the same parties but with the Underwriter acting as Placement Agent.

24. ***Deliver Offering Documents in Final Form.*** A final Official Statement containing the final bond sale information is printed and delivered to purchasers of the senior lien bonds at or before receipt of their purchase confirmations. A final Limited Offering Memorandum is printed and delivered to purchasers of the subordinate lien bonds at or before receipt of their purchase confirmations.

25. ***Close Bond Issue.*** At the bond closing, the senior lien bonds are delivered to the Underwriter in exchange for the purchase price. The subordinate lien bonds are delivered to the purchasers thereof in exchange for their purchase price. Simultaneously, final executed copies of the financing and project documents and various certificates, receipts and opinions are exchanged among all the principal parties.

B. Timetable

A typical bond issue for a hotel project takes approximately 6-9 months from start to finish. For example, assume at least 1-3 months for steps 1-11 (i.e., structuring the issue and circulating first drafts of the basic financing documents and project documents), another 1-3 months for steps 12-20 (i.e., to finalize documentation and obtain approvals, ratings and, if applicable, credit enhancement), 3 weeks to 3 months for steps 21-24 (i.e., for the Underwriter to market the bonds), followed in about two weeks with step 25 (the closing).

If a nonprofit corporation is to be created as part of the financing, creation of a nonprofit corporation and obtaining a 501(c)(3) determination from the I.R.S. generally takes 4-6 months, which period can run concurrently with steps 1-20 above.

These timeframes are fairly representative but may in each case take longer if circumstances require.

CHAPTER EIGHT

Case Studies

A. Chicago, Illinois McCormick Place Convention Complex Hospital Facilities

In March 1996, the Metropolitan Pier and Exposition Authority issued one series of bonds in the principal amount of $127.4 million to finance the construction of a 800-room convention center hotel to be operated by the Hyatt Corporation under a Hyatt flag and a 600-space parking structure. This financing was one of the first tax-exempt hotel financings structured on a non-recourse basis. The hotel is located adjacent to the McCormick Place Convention Center in Chicago, Illinois. The Metropolitan Pier and Exposition Authority, a public entity of Illinois, is the Hotel Owner as well as the owner of the McCormick Place Convention Center. This financing was structured without the use of a Developer or Asset Manager. The Contractor was an Illinois corporation and A. Epstein & Sons International, Inc. was the Project Architect. The bonds were rated BBB- by Standard & Poor's and were secured by the net revenues of the hotel and the parking garage. In addition, the bonds were secured by the agreement of the Authority to transfer to the bond trustee $700,000 annually of unrestricted gross revenues received by the Authority for the payment of debt service on the bonds. The laws under which the bonds were issued did not allow the bonds to be secured by a mortgage on the hotel or the garage. The Authority made a substantial equity contribution to the project.

B. Austin-Bergstrom International Airport Hotel

In February 1999, the Austin-Bergstrom Landhost Enterprises, Inc., a nonprofit corporation established as an instrumentality of the City of Austin and qualifying as

a “63-20 corporation,” issued senior lien bonds in the principal amount of $38.8 million and subordinate lien bonds in the principal amount of $3.7 million to finance a portion of the construction of a 265-room airport hotel to be operated by Briston Hotel & Resorts under a Hilton flag at the Austin-Bergstrom International Airport. The Developer was Landmark Hospitality, L.P., the General Contractor was Landmark Organization, L.P., an affiliate of the Developer and the Hotel Owner is the Austin-Bergstrom Landhost Enterprises, Inc. The Developer also acts as Asset Manager. Both the senior lien bonds and the subordinate lien bonds are unrated. The bonds are secured by the net hotel revenues and a leasehold deed of trust. The subordinate lien bonds were structured as capital appreciation bonds.

C. Cambridge, Maryland /Chesapeake Bay Conference Center Hotel

In November 1999, the Maryland Economic Development Corporation issued two series of senior lien bonds in the combined principal amount of $127.2 million and one series of junior lien bonds in the principal amount of $7 million to finance the construction of a 18-hole golf course, 150-slip marina, 400-room hotel and conference center to be operated under a management agreement by the Hyatt Corporation. The Maryland Economic Development Corporation, a public instrumentality of the State of Maryland, is the owner of the project (the site was leased by the Maryland Economic Development Corporation from Chesapeake Resort, LLC under a lease for a term that exceeded the final maturity date of the bonds). The Developer was QDC Development Services, L.L.C., the General Contractor was The Clark Construction Group, Inc. and the Asset Manager was QDC Asset Management, L.L.C. An independent Construction Monitor was also required. Both the senior lien bonds and the junior lien bonds were unrated. The senior lien bonds and the junior lien bonds were secured by net revenues of the project and a deed of trust.

D. Sacramento, California Convention Center Hotel

In April 1999, the Sacramento City Financing Authority issued senior lien bonds in the principal amount of $92.8 million and subordinate lien bonds in a principal amount of $4.1 million to finance the construction of a 500-room convention center hotel to be operated by Sheraton Operating Corporation under a Sheraton flag. The hotel is located adjacent to the Sacramento Convention Center and opened in Spring of 2001. The Developer was Public Market Building, LLC, the General Contractor was Hensel Phelps Construction Co. and the Hotel Owner is the Sacramento Hotel Corporation, a nonprofit corporation established as an instrumentality of the City of Sacramento. In this case, the Developer also acts as the Asset Manager. Both senior lien bonds and subordinate lien bonds were unrated. In addition to being secured by the net revenues of the hotel, the senior lien bonds and subordinate lien bonds were also secured by the net revenues of an existing City-owned parking garage located across the street from the hotel. Furthermore, the senior lien bonds and subordinate lien bonds were secured by a deed of trust on the hotel and a leasehold deed of trust on the parking garage. A portion of the cost of the hotel in the amount of $8 million was funded by the Redevelopment Agency of the City of Sacramento. The Developer conveyed to the Corporation a portion of the land on which the hotel is located and certain improvements in exchange for cash and the subordinate lien bonds. The subordinate lien bonds were structured as capital appreciation bonds.

E. Overland Park, Kansas Convention Center Hotel

In January 2001, the Overland Park Development Corporation, a nonprofit corporation established as an instrumentality of the City of Overland Park and qualifying as a "63-20 corporation," issued three series of bonds in a total principal amount of approximately $87 million to finance the construction of a 412-room convention center hotel to be operated by Sheraton Operating Corporation under a Sheraton flag. The hotel is to be located adjacent to the Overland Park Convention Center that is being constructed by the City concurrently with the construction of the hotel. The Developer is OPHC, LLC, the Design/Builder is Turner Construction Company and the Hotel Owner is the Overland Park Development Corporation.

In this case, the Developer also acts as the Asset Manager. The first tier bonds ($62.53 million) were rated BBB- by Fitch, Inc. and the second tier bonds ($24.6 million) and third tier bonds ($5 million) were unrated. In addition to a pledge of hotel revenues, the first and second tier bonds were secured by a mortgage on the Corporation's leasehold interest in the hotel project (site was leased from the City). In addition, the City subordinated its fee interest in the hotel site to the bond trustee to secure the obligations of the Corporation with respect to the bonds. The City agreed, subject to annual appropriation, to make annual revenues of its transient guest tax available for the payment of debt service on the first and second tier bonds in the event of insufficiency in hotel revenues. The first and second tier bonds were publicly offered and the third tier bonds were purchased by the Developer and the General Contractor. The third tier bonds were structured as capital appreciation bonds.

F. Myrtle Beach, South Carolina Convention Center Hotel

In June 2001, the South Carolina Jobs – Economic Development Authority issued senior lien bonds in the principal amount of $40.845 million and subordinate lien bonds in the principal amount of $23.5 million to finance the construction of a 404-room hotel to be managed and operated by Radisson Myrtle Beach LLC, a wholly-owned direct subsidiary of Radisson Hotel Corporation, under the Radisson flag. The hotel is to be located next to the Myrtle Beach Convention Center. The Project Manager is Usry Wolfe Kroll Architecture, Inc., the General Contractor is WELBRO Constructors, S.C., Inc., the Construction Monitor is Staley Company and the Hotel Owner is the Myrtle Beach Convention Center Hotel Corporation, a nonprofit corporation established as an instrumentality of the City of Myrtle Beach. This transaction was unique because the subordinate lien bonds were insured by MBIA Corporation and therefore carried a higher rating (AAA/Aaa) than the senior lien bonds (BBB- from Standard & Poor's) and were therefore marketed to the public. The bonds were secured by a leasehold deed of trust (site was leased from the City). In addition, the subordinate lien bonds were secured by the City's limited guarantee, subject to appropriation, to replenish amounts withdrawn from the subordinate debt service reserve account.

G. Austin, Texas Convention Center Hotel

Also in June 2001, the Austin Convention Enterprises Inc., a nonprofit corporation established as an instrumentality of the City of Austin and qualifying as a "63-20 corporation," issued three series of bonds in a total principal amount of $265 million to finance the construction of an 800-room hotel to be operated by Hilton Hotels Corporation under the Hilton flag and a 600-space underground garage. The hotel is to be located next to the newly expanded Austin Convention Center. The Developer is H.L. Hotels, L.P., the Design/Builder is Landmark Organization, L.P., the Construction Monitor was Levien-Rich Associates, Inc. and the Hotel Owner is the Austin Convention Enterprises Inc. The first tier bonds ($109.665 million) were rated Baa3 (Moody's) and BBB- (Standard & Poor's). The second tier bonds ($134.95 million) were insured by ZC Special Insurance Co., and similar to the Myrtle Beach financing described above, the second tier bonds carried a higher rating than the first tier bonds and were therefore sold to the public. The third tier bonds ($20.5 million) were purchased by the Developer (and an affiliate of the Developer) and the Hotel Operator. A deed of trust secured all three series of the bonds. In addition, pursuant to an economic development program, the City of Austin granted $15 million on the date of issuance of the bonds for deposit in the project account held under the indenture to cover a portion of the cost of construction of the hotel.