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REAL ESTATE GAZETTE

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TURNING THE SPOTLIGHT ON THE HOSPITALITY AND LEISURE SECTOR IN SOME OF THE WORLD'S KEY JURISDICTIONS

ISSUE 21

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A NOTE FROM **THE EDITOR**

The twenty-first issue of the DLA Piper Real Estate Gazette highlights issues relating to the hospitality and leisure industry.

Welcome to Issue 21 of DLA Piper's *Real Estate Gazette*. At the end of the northern hemisphere summer many people have just returned from time spent relaxing in idyllic surroundings. However, what about the massive business sector that facilitates this? In this issue, we turn the spotlight on the hospitality and leisure sector in some of the world's key jurisdictions, focusing on topics that are intricately linked with real estate.

In our International article (page 6), we examine the form taken by the hotel management agreements that allow investors to benefit from the income generated by their hotel assets, and we update the results of our 2011 review of how these agreements work internationally. We were interested to note that many of the trends that had begun to emerge in 2011 continue to be seen currently, and that despite signs of an economic recovery, the persistent fear of risk in many markets has seen an increased use of management agreements as a way of limiting operators' exposure to fixed costs. The section goes on to feature (among others) articles from Denmark, describing the impact of a proposed relaxation in the planning laws there that is expected to lead to greater freedom to develop near the coastline (page 16); from France, explaining the ways in which hotel owners should negotiate rent on renewal of a lease (page 18), and also considering the issues involved when it is proposed to convert an office building into a hotel (page 20); from Dubai, exploring the rise of the Lessor's Non-Disturbance Agreements (page 24); and from Romania, describing the key issues relating to fire safety in hotels (page 28).

Also discussed in this issue are recent changes to the tax regime in Australia, which are particularly significant for international investors in Australian real estate (page 36). In our Japanese article (page 38), we examine the most common investment structures considered by foreign investors wishing to acquire property in Japan, some of which are unique to the country and have no equivalent in other developed legal systems. The issue closes with a detailed look at the approach of the US Congress to encouraging overseas investment in US real estate, highlighting recent proposals to use international tax reform as a source of funding transportation infrastructure investment that have attracted bipartisan support in both the House of Representatives and the Senate (page 44).

We do hope you will enjoy reading our views, and if you would like more information on any of the topics featured in this issue, please do get in touch. You can find contact details for all our contributors on the opposite page.

Olaf Schmidt, Head of International Real Estate

“Despite signs of an economic recovery, many markets remain risk averse.”

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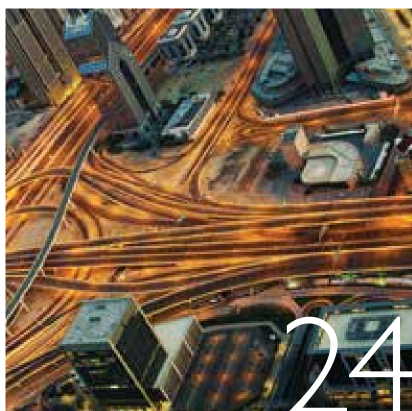

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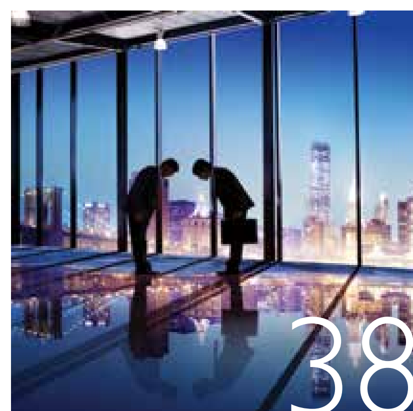


HOTEL MANAGEMENT AGREEMENTS—A GLOBAL APPROACH

JOANNE OWEN, LONDON

The form taken by hotel management agreements (HMAs) is an important factor in the effective working of the market in hotel investment. DLA Piper's Hospitality and Leisure Sector Group works closely with the firm's Real Estate Sector Group in negotiating these agreements for clients in all of the world's key jurisdictions. In 2011 we carried out a review of how HMAs were working internationally. With the publication of an issue of our *Real Estate Gazette* devoted to the hospitality sector we thought it was time to re-visit HMAs. The commentary in this article is a result of that review.

In summary, since 2011, we have found that trends that started as a result of the financial crisis of the last decade have continued to develop. In many markets the advent of recession made operators more risk averse. HMAs were a means to limit operators' exposure to fixed rental payments when revenues were dropping. In less developed markets, such as Romania and the UAE, even with a degree of economic recovery, operators have continued to use HMAs in this way. In more developed markets, such as Spain and the UK, we have seen increased complexity in agreements, including the emergence of the "manchise"—a more complex hybrid arrangement combining elements of franchising and the guaranteed tranches of income found in leases with the features of a traditional HMA. This is a symptom of owners becoming more knowledgeable and seeking more control and input.

Another important factor, as with any real estate investment, is the attitude of those who are providing the finance. In many ways banks remain traditional. They know and understand a lease arrangement. HMAs offer less certainty. Due to the demands of the market it becomes essential to have an understanding of lenders and be able to work with them in a scenario of increasingly complex legal arrangements.

The table that makes up the rest of this article sets thirteen questions about the current workings of HMAs in various countries and their interaction with other contractual arrangements. We have assembled answers to these questions from a total of fourteen jurisdictions. The local differences in practice and market peculiarities we have identified will give any international investor food for thought. Some of the technical expressions used in the table are explained immediately below:

- ***Non-Disturbance Agreements* (NDA).** An agreement between a hotel's owner, operator and the owner's lending bank whereby the bank agrees that if the owner defaults under its loan and the bank forecloses, the bank will keep the HMA in place. The bank will usually have the right to step in and cure an owner's default under the HMA.
- ***"Non-Compete" or "Radius" Clauses*.** An owner will often insist that the operator does not open another hotel with the same brand within a certain radius, either for the whole of the term of the HMA or for a specified period. Operators with large portfolios comprising a number of brands will normally seek to exclude some of the brands from the non-compete clause.
- ***RevPAR*.** The abbreviation for rooms revenue per available room, namely the gross rooms revenue of the hotel divided by the number of room nights available (which also equals the average daily rate multiplied by the occupancy). This is the primary benchmark for measuring the performance of hotels.

BELGIUM

Do you have HMAs in your jurisdiction?	Yes.
If not, what are the alternatives/ what is commonly used?	Although less standard, the alternative is a commercial rental agreement where the business activity of the relevant hotel is carried out by a lessee who, in consideration for a rent (fixed and proportional) will run the hotel on its own account, and not on the account of the owner.
How have HMAs stood up during the recession? Has the recession changed the form of HMAs? Has there been a decline or increase in their use?	The use of HMAs has increased as operators prefer to link management fees to profit only.
What is the standard term of a management contract?	15–20 years, usually with a renewal option.
What are the standard base fees that the operator receives?	2–3%.
What other fees and charges are there (such as accounting, marketing, license (sic) fees, etc)?	All fees related to the operation of the hotel (marketing fees, accounting fees, advertising fees, etc), taxes applicable to the hotel and its operation, insurance costs covering the hotel, maintenance and repair of the hotel, energy and water costs, operating licenses and permits, personnel costs.
What percentage of gross revenue is commonly set aside as FF&E reserve?	5%.
Is an operator guarantee common in your jurisdiction?	It depends on the SPV and the operator.
What performance measures are commonly used in your jurisdiction?	Total revenues of the hotel in accordance with the Uniform System of Accounts.
Is it usual to have a non-compete clause, e.g. that no other property with that brand can open within a certain radius?	Yes, certainly in a competitive city such as Brussels.
In your country, does the balance of power lie more with the owner or the operator?	An appropriate balance is reached in each specific contract depending on the investment of the owner/ operator.
Does the HMA give lease rights?	No.
Is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?	Yes.

CZECH REPUBLIC

Do you have HMAs in your jurisdiction?	Yes, however there is no statutory regulation of HMAs.
If not, what are the alternatives/ what is commonly used?	Commonly, a combination of a lease and mandate / procurement agreement is used.
How have HMAs stood up during the recession? Has the recession changed the form of HMAs? Has there been a decline or increase in their use?	There has been no significant change.
What is the standard term of a management contract?	10–20 years.
What are the standard base fees that the operator receives?	2–4%.
What other fees and charges are there (such as accounting, marketing, license fees, etc)?	Incentive fee from gross operating profit, reservation fees, marketing, and license fees.
What percentage of gross revenue is commonly set aside as FF&E reserve?	This depends on the age and condition of the relevant furniture and equipment. Usually 1% of gross revenues at beginning of the term increasing each year up to 5% after 5 years.
Is an operator guarantee common in your jurisdiction?	This is at the parties' discretion.
What performance measures are commonly used in your jurisdiction?	Occupancy rate, desk room rate, average actual room rate.
Is it usual to have a non-compete clause, e.g. that no other property with that brand can open within a certain radius?	This is recommended.

In your country, does the balance of power lie more with the owner or the operator?	The operator, but the owner may require some degree of contractual participation.
Does the HMA give lease rights?	This is at the parties' discretion.
Is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?	For a lease agreement, it is not necessary. Czech statute law protects the rights of the lessee if, e.g., by enforcement of a mortgage, the owner of the hotel property will change. For a management contract, it can be desirable to have an NDA.

FRANCE

Do you have HMAs in your jurisdiction?	Yes.
If not, what are the alternatives/ what is commonly used?	Although less standard, the alternative is a business rental agreement where the business activity of the subject hotel is carried out by a lessee who, in consideration of a rent (fixed and proportional) will run the hotel on its own account, and not on the account of the owner.
How have HMAs stood up during the recession? Has the recession changed the form of HMAs? Has there been a decline or increase in their use?	There have been no major changes, though base fees have often been temporarily reduced. Operator guarantees have faded away.
What is the standard term of a management contract?	30 years.
What are the standard base fees that the operator receives?	3%.
What other fees and charges are there (such as accounting, marketing, license fees, etc)?	Room reservation networks, software licenses, trademarks and IP, marketing services.
What percentage of gross revenue is commonly set aside as FF&E reserve?	0–5% depending on the segment and age of the hotel.
Is an operator guarantee common in your jurisdiction?	Yes, but only for an initial limited period (up to 5 years).
What performance measures are commonly used in your jurisdiction?	Performance tests using either/ both of own performance threshold and comparison with competitive set of hotels.
Is it usual to have a non-compete clause, e.g. that no other property with that brand can open within a certain radius?	It is quite unusual for top brands, but becomes more usual the further away the brand is from the top end.
In your country, does the balance of power lie more with the owner or the operator?	The operator, except for a very limited range of matters where the owner will maintain the equivalent of veto rights (e.g., the opening of a casino).
Does the HMA give lease rights?	No.
Is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?	French bankruptcy law makes a substantial part of the provisions that operators look for unworkable, so that although NDAs are still common practice they mostly contain reciprocal advance notice of action provisions for the benefit of operator and lender.

GERMANY

Do you have HMAs in your jurisdiction?	The German market is still dominated by rather conservative investors preferring lease agreements. However, HMAs as well as "hybrid" agreements with lease and management elements are used increasingly.
If not, what are the alternatives/ what is commonly used?	The alternative, a lease agreement, is still being used and is mostly preferred by property owners due to the stable and predictable income. HMAs are seen as riskier, and many German players do not see a commercial benefit in a hotel management agreement, and prefer to take the safe option.
How have HMAs stood up during the recession? Has the recession changed the form of HMAs? Has there been a decline or increase in their use?	While the recession did not really influence the content of HMAs, it certainly contributed to HMAs being used more often. Hotel operators are keen to keep risks to a minimum and they can do this effectively through an HMA. As the brand becomes increasingly important large hotel operators can often impose their choice of an HMA. Sometimes the banks insist on a "regular" lease agreement. The crisis has now passed and the German hotel market is booming. However, the above still applies.
What is the standard term of a management contract?	A typical term would be 15 or 20 years.
What are the standard base fees that the operator receives?	We quite often see base management fees at a level of 2–4% of gross revenue.

What other fees and charges are there (such as accounting, marketing, license fees, etc)?	An incentive fee of 8–12% of GOP. Sometimes parties agree on certain incentive management fees which are applicable when a certain turnover is exceeded. Other fees usually agreed relate to contributions to accounting and reservation systems and to marketing efforts.
What percentage of gross revenue is commonly set aside as FF&E reserve?	3–5% per annum. Sometimes parties agree on 1% at the beginning of the contractual period rising to 5% after 10 years.
Is an operator guarantee common in your jurisdiction?	It depends on the individual agreement. Most operators try to avoid such guarantees. Sometimes the whole project is not bankable without.
What performance measures are commonly used in your jurisdiction?	The respective clauses are rather vague and there is not really a common standard in Germany. Sometimes there are reporting obligations only. In a few contracts we have seen termination rights in cases of poor performance.
Is it usual to have a non-compete clause, e.g. that no other property with that brand can open within a certain radius?	Yes.
In your country, does the balance of power lie more with the owner or the operator?	The balance of power tends to lie with the operator.
Does the HMA give lease rights?	No, an HMA does not give lease rights, but it gives similar usage rights insofar as the operator needs the premises in order to be able to perform its services.
Is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?	This is fairly unusual in Germany.

HUNGARY

Do you have HMAs in your jurisdiction?	Yes.
If not, what are the alternatives/ what is commonly used?	A lease agreement, which includes the operation of the hotel as one of the tenant's obligations.
How have HMAs stood up during the recession? Has the recession changed the form of HMAs? Has there been a decline or increase in their use?	The terms of HMAs have not changed but there has been a decline in their use due to the downturn in transactional activity. Sometimes parties struggle between HMAs and lease agreements, mainly to meet the requirements set by the financier.
What is the standard term of a management contract?	10–20 years, often with renewal options.
What are the standard base fees that the operator receives?	2.5–3%.
What other fees and charges are there (such as accounting, marketing, license fees, etc)?	Incentive management fees, sales costs, marketing costs, advertising expenses, personnel training costs, utility and energy costs, operating licenses and permits.
What percentage of gross revenue is commonly set aside as FF&E reserve?	This depends primarily on the condition of the hotel and the furniture and other equipment installed in it. Usually the percentage is established in the annual plan (approved by the owner).
Is an operator guarantee common in your jurisdiction?	Yes—it is often capped at a certain amount or restricted to a certain period within the whole term of the HMA.
What performance measures are commonly used in your jurisdiction?	Typically the Uniform System of Accounts for the Lodging Industry published by the American Hotel and Lodging Association.
Is it usual to have a non-compete clause, e.g. that no other property with that brand can open within a certain radius?	Yes.
In your country, does the balance of power lie more with the owner or the operator?	Although the balance of power tends to lie more with the operators, this depends on who the parties are. When one of the parties belongs to the first tier of hotel management companies, the HMA is almost certain to benefit the operator.
Does the HMA give lease rights?	Typically no. "Hybrid" agreements are, however, not uncommon. In this case the operator not only operates but also leases a part or the whole of the hotel.
Is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?	An NDA is often required.

ITALY

Do you have HMAs in your jurisdiction?	Yes.
If not, what are the alternatives/ what is commonly used?	Not applicable.
How have HMAs stood up during the recession? Has the recession changed the form of HMAs? Has there been a decline or increase in their use?	It is now common to require specific guarantees from the operator, which were not required in the past.
What is the standard term of a management contract?	10 years.
What are the standard base fees that the operator receives?	2–3%.
What other fees and charges are there (such as accounting, marketing, license fees, etc)?	Marketing fees, license fees, incentives.
What percentage of gross revenue is commonly set aside as FF&E reserve?	3–4%.
Is an operator guarantee common in your jurisdiction?	Such guarantees are increasingly common.
What performance measures are commonly used in your jurisdiction?	REVPAR Index, GOP, Actual Performance Compared to Budget, Position in Competitive Set.
Is it usual to have a non-compete clause, e.g. that no other property with that brand can open within a certain radius?	Yes, but only with 5-star or higher rated hotels.
In your country, does the balance of power lie more with the owner or the operator?	This depends on the value of the real estate asset. With luxury hotels in key locations the balance of power definitely lies with the owner.
Does the HMA give lease rights?	No.
Is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?	An NDA is often required. For high end hotels an NDA is always entered into.

KINGDOM OF SAUDI ARABIA

Do you have HMAs in your jurisdiction?	Yes—this is the method by which most of the internationally branded hotels are operated. The HMA tends to be accompanied by a technical services agreement, central services agreement and license agreement. HMAs tend to relate to hotels yet to be constructed so we do not see many "conversion" deals.
If not, what are the alternatives/ what is commonly used?	We are slowly starting to see franchise agreements being used as a small number of experienced hotel owners start to emerge as potentially suitable franchisees. There is no formal unified law relating to landlord and tenant relationships in the Kingdom and decisions are made regarding disputes at a municipality level so there is considerable uncertainty regarding leasehold relationships. There are also restrictions on foreign entities taking long leases. Therefore, we do not see hotel leases.
How have HMAs stood up during the recession? Has the recession changed the form of HMAs? Has there been a decline or increase in their use?	There have been no significant changes and HMAs remain the most common model for operating a hotel in the Kingdom.
What is the standard term of a management contract?	15–25 years, with one or two 5- or 10-year renewal options.
What are the standard base fees that the operator receives?	1.5–2%.
What other fees and charges are there (such as accounting, marketing, license fees, etc)?	Marketing fees (between 1% and 2%). Central services (allocated differently depending on the precise service). License fees (between 1.5% and 2.5%). Incentive fees (between 6% and 10%).
What percentage of gross revenue is commonly set aside as FF&E reserve?	Generally: 1% in year 1, 2% in year 2, 3% in year 3, 4% in year 4, then from year 5 onwards it is 5%.
Is an operator guarantee common in your jurisdiction?	No—we have never seen this in an HMA deal in the Kingdom.

What performance measures are commonly used in your jurisdiction?	The performance test tends to be a two-limbed test of RevPAR against a competitive set of hotels and gross operating profit being not less than e.g. 85% of budgeted gross operating profit.
Is it usual to have a non-compete clause, e.g. that no other property with that brand can open within a certain radius?	This is fairly common.
In your country, does the balance of power lie more with the owner or the operator?	There is rapid growth in the hotel sector in the Kingdom so, on balance, operators have a slightly greater balance of power.
Does the HMA give lease rights?	No—for the reasons discussed earlier.
Is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?	It is not very common but we have seen it from time to time. Due to local laws, there are issues around the enforceability of NDAs.

NORWAY

Do you have HMAs in your jurisdiction?	Yes, but lease agreements are more commonly used.
If not, what are the alternatives/ what is commonly used?	For many property owners the preferred structure is a lease agreement. Lease agreements secure a steady income and it is considered easier for the owner to value and sell the property based on an annual rental income.
How have HMAs stood up during the recession? Has the recession changed the form of HMAs? Has there been a decline or increase in their use?	There have been no significant changes.
What is the standard term of a management contract?	15 years or more.
What are the standard base fees that the operator receives?	3%.
What other fees and charges are there (such as accounting, marketing, license fees, etc)?	Chain services, advertising expenses, reward packages etc.
What percentage of gross revenue is commonly set aside as FF&E reserve?	This varies, and usually increases during the term of the management contract.
Is an operator guarantee common in your jurisdiction?	Yes.
What performance measures are commonly used in your jurisdiction?	There is no common standard.
Is it usual to have a non-compete clause, e.g. that no other property with that brand can open within a certain radius?	Yes.
In your country, does the balance of power lie more with the owner or the operator?	The balance of power mostly lies with the owner.
Does the HMA give lease rights?	No.
Is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?	No.

POLAND

Do you have HMAs in your jurisdiction?	Yes.
If not, what are the alternatives/ what is commonly used?	HMAs are standard. The alternative to HMAs are lease agreements. Currently, we are also seeing a significant increase in franchising agreements in the Polish market. From the perspective of a franchisor, this form guarantees both the highest income and the least number of problems.
How have HMAs stood up during the recession? Has the recession changed the form of HMAs? Has there been a decline or increase in their use?	There has been no change in relation to international hotel brands. The recession speeded up the development of the domestic companies providing hotel management services. Since hotel chains now offer mainly franchise arrangements, often on more beneficial conditions, there are more and more companies providing franchising management services.
What is the standard term of a management contract?	20+ years for large international hotels. It can be as little as 3 years for domestic hotels.
What are the standard base fees that the operator receives?	3–5% and up to 12% of the hotel's operating income.

What other fees and charges are there (such as accounting, marketing, license fees, etc)?	Entry fees, reservation fees, trade mark fees, loyalty package fees, adaptation (standardization) fees.
What percentage of gross revenue is commonly set aside as FF&E reserve?	In general, it seems not to be specified. Finishing materials and fitting elements are selected in a way which does not require changing them for at least 10 (or even more) years. Then, a complete renovation is arranged and the parties agree the actual needs, scope and funds.
Is an operator guarantee common in your jurisdiction?	No.
What performance measures are commonly used in your jurisdiction?	It depends on the different management companies rather than on the market standard but the most common performance measures are occupancy rate, GOP and RevPAR.
Is it usual to have a non-compete clause, e.g. that no other property with that brand can open within a certain radius?	It is typical for the hotels of the same brand that are owned by the operator. It is rather rare when it comes to any other hotels.
In your country, does the balance of power lie more with the owner or the operator?	It depends on the negotiating skills of the owner company, the location and facility potential and the experience of the company's representatives in hotel activities.
Does the HMA give lease rights?	No.
Is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?	No.

ROMANIA

Do you have HMAs in your jurisdiction?	Yes.
If not, what are the alternatives/ what is commonly used?	As well as HMAs, owners choose hotel franchise/ long lease agreements.
How have HMAs stood up during the recession? Has the recession changed the form of HMAs? Has there been a decline or increase in their use?	There has been an increase in the use of HMAs since hotel companies have found that they can avoid the risks of ownership and operation while securing a constant stream of income by entering into long term, non-terminable management agreements, and they are more beneficial to operators. The terms of these agreement have increased.
What is the standard term of a management contract?	10–20 years, depending on the operator.
What are the standard base fees that the operator receives?	2–4%.
What other fees and charges are there (such as accounting, marketing, license fees, etc)?	Sales and marketing costs, accounting charges, purchasing costs, and license/ franchise fees. These are often set as a percentage of rooms' revenue, and typically range from 1–4% of gross rooms revenue.
What percentage of gross revenue is commonly set aside as FF&E reserve?	The typical reserve is 3–5% of total revenue.
Is an operator guarantee common in your jurisdiction?	Yes.
What performance measures are commonly used in your jurisdiction?	The performance test used in our jurisdiction is that of measuring the GOP achieved for an operating year with the pre-agreed percentage of GOP. In practice, there are other performance tests used, such as AGOP (Adjusted GOP) or EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization).
Is it usual to have a non-compete clause, e.g. that no other property with that brand can open within a certain radius?	Yes.
In your country, does the balance of power lie more with the owner or the operator?	In Romania, the operator has more control over the operation of the asset.
Does the HMA give lease rights?	Yes.
Is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?	No.

RUSSIA

Do you have HMAs in your jurisdiction?	Yes, but we break up the overall services into several contracts for tax reasons: an HMA is entered into with a local branch company and then a separate license agreement, and central services and technical services agreements are entered into with various offshore operator entities.
If not, what are the alternatives/ what is commonly used?	Not applicable.
How have HMAs stood up during the recession? Has the recession changed the form of HMAs? Has there been a decline or increase in their use?	No dramatic change.
What is the standard term of a management contract?	20 years (plus one or two five-year extensions mutually agreed). Some operators do not agree a term less than 20 years (e.g. Fairmont Raffles Hotels International, Marriott, Rezidor).
What are the standard base fees that the operator receives?	3% as a starting point, but it can usually be slightly reduced (to between 2.5 and 2.8%) over the term or at least for the first three to four years.
What other fees and charges are there (such as accounting, marketing, license fees, etc)?	A license fee of 10% or, more commonly, on a scale of 6 to 10% based on the GOP performance. Central services are usually 1.5% of the total revenue or 2.25–2.5% of a room's revenue. Also some charge for loyalty plans and for reservations, either a fee per room or $5–$9 per booking.
What percentage of gross revenue is commonly set aside as FF&E reserve?	4–5% of total revenue (in general). In the first five years it may be less (e.g. first year—2%, second—3%, etc).
Is an operator guarantee common in your jurisdiction?	It was common several years ago, but only for a short period (of between three to five years). Nowadays, it is seen less often.
What performance measures are commonly used in your jurisdiction?	A performance test (with the HMA terminable after 3–4 years provided unless conditions relating to budget performance and comparison with competitors' performance are satisfied for at least two consecutive years). An operator's fees will depend on revenue.
Is it usual to have a non-compete clause, e.g. that no other property with that brand can open within a certain radius?	Yes, but usually not for the whole term (e.g. it expires if the hotel has more than 60–70% occupancy).
In your country, does the balance of power lie more with the owner or the operator?	Usually the owner, however it depends on the location. If the operator wants to secure a location, it will be more flexible.
Does the HMA give lease rights?	No.
Is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?	Yes, it is seen more often.

SPAIN

Do you have HMAs in your jurisdiction?	Yes, however management agreements as drafted and imposed by international chains have never been popular amongst hotel owners, many of whom wish to have some involvement in the management of the property. This may explain why the penetration of international chains in Spain has not been high.
If not, what are the alternatives/ what is commonly used?	Lease agreements are the most common alternative to hotel management agreements. They are preferred by traditional landlords and are still widely used because owners consider them to be safer and involve less management risk. Franchise agreements are also taking off in Spain.
How have HMAs stood up during the recession? Has the recession changed the form of HMAs? Has there been a decline or increase in their use?	In a period of recession, owners have been more reluctant to enter into HMAs and have tended to use what they perceive to be safer management structures: standard lease agreements where the hotel operator would just lease the property for the development of its hotel business, or franchise agreements where the hotel owner would manage the property under the umbrella of the franchisor's know-how.
What is the standard term of a management contract?	It is difficult to set a standard term for management contracts in Spain. The term of the agreement varies depending on the manager's policy or standard terms. However it can be said that, in line with international trends, the term of management contracts is now shorter than it used to be prior to the recession.
What are the standard base fees that the operator receives?	Again, it depends more on the various management companies' standard and on the negotiating strength of the owner than on market practice. It must be said however that the recession has reduced base fees substantially.

What other fees and charges are there (such as accounting, marketing, license fees, etc)?	HMAs in Spain include several ancillary fees, which again depend on the leverage of the operator during negotiations.
What percentage of gross revenue is commonly set aside as FF&E reserve?	No percentage can be considered standard.
Is an operator guarantee common in your jurisdiction?	No.
What performance measures are commonly used in your jurisdiction?	It depends more on the standard of the various management companies than on any given market standard but most HMAs include performance tests which apply once a reasonable term has elapsed from the date of the agreement.
Is it usual to have a non-compete clause, e.g. that no other property with that brand can open within a certain radius?	Radius restriction clauses are found in many HMAs.
In your country, does the balance of power lie more with the owner or the operator?	Traditionally in HMAs the balance of power lay with the operator, although the recession changed this. Owners now have more leverage when an operator has an interest in being present in a given market or when the property they own has specific features that attract the interest of operators.
Does the HMA give lease rights?	No.
Is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?	NDA agreements are really not enforceable in Spain and therefore are not standard.

UNITED ARAB EMIRATES

Do you have HMAs in your jurisdiction?	Yes—this is the method by which most of the internationally branded hotels are operated. The HMA tends to be accompanied by a technical services agreement, central services agreement and license agreement. HMAs tend to relate to hotels yet to be constructed so we do not see many "conversion" deals.
If not, what are the alternatives/ what is commonly used?	We are slowly starting to see franchise agreements being used as a small number of experienced hotel owners start to emerge as potentially suitable franchisees. Hotel leases are not generally used other than for small, locally operated, non-branded hotels. There are also restrictions on foreign companies entering into long leases in areas that are not designated for "foreign" ownership and it can be very difficult to terminate leases in the UAE, so this approach is not generally used by international operators.
How have HMAs stood up during the recession? Has the recession changed the form of HMAs? Has there been a decline or increase in their use?	There have been no significant changes and HMAs remain the most common model for operating a hotel in the UAE. As hotel operators strive to have an increasing number of rooms under contract in the region, and the UAE hotel market becomes more saturated, some hotel operators are accepting considerable concessions in order to sign an HMA, e.g., removing their base fee and receiving incentive fees only.
What is the standard term of a management contract?	15–25 years, with one or two 5- or 10-year renewal options.
What are the standard base fees that the operator receives?	1.5–2% (although see previous comment about some operators now waiving their base fee).
What other fees and charges are there (such as accounting, marketing, license fees, etc)?	Marketing fees (between 1% and 2%). Central services (allocated differently depending on the precise service). License fees (between 1.5% and 2.5%). Incentive fees (between 6% and 10%).
What percentage of gross revenue is commonly set aside as FF&E reserve?	Generally: 1% in year 1, 2% in year 2, 3% in year 3, 4% in year 4, then from year 5 onwards 5%. This may be increased in the case of a very high end brand. Increasingly we are seeing hotel operators willing to be flexible in terms of how such money is held, e.g., notional reserves with a bank guarantee, sums above a certain amount can be used for capital expenditure etc.
Is an operator guarantee common in your jurisdiction?	No—we have never seen this in an HMA deal in the UAE.

What performance measures are commonly used in your jurisdiction?	The performance test tends to be a two-limbed test of RevPAR against a competitive set of hotels and gross operating profit being not less than e.g. 85% of budgeted gross operating profit.
Is it usual to have a non-compete clause, e.g. that no other property with that brand can open within a certain radius?	This is fairly common.
In your country, does the balance of power lie more with the owner or the operator?	In the last one or two years, operators have had to compete harder for deals and therefore owners are able to get better terms than a few years ago.
Does the HMA give lease rights?	No—for the reasons discussed earlier.
Is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?	It is becoming more common but not "standard". There are issues due to local law around the enforceability of NDAs.

UNITED KINGDOM

Do you have HMAs in your jurisdiction?	Yes. When compared to a lease they have no investment risk for operators. Maintenance costs, capital expenditure and employee costs are the responsibility of the owner.
If not, what are the alternatives/ what is commonly used?	Franchise arrangements and less typically lease structures (sometimes including bespoke rent provisions including turnover rents and performance rents). Some landlords and investors still remain nervous about retaining liabilities for the building and valuing anything other than a traditional triple net lease agreement.
How have HMAs stood up during the recession? Has the recession changed the form of HMAs? Has there been a decline or increase in their use?	The recession has certainly brought about some changes especially in the amount of money being put into the FF&E reserve and ways of collaborating on expenditure relating to big assets. The recession has also made banks far less likely to agree to NDAs.
What is the standard term of a management contract?	20 years with renewal options. Upscale operators can command longer initial contract terms.
What are the standard base fees that the operator receives?	2–4% of total revenue, though occasionally 1% is the base fee.
What other fees and charges are there (such as accounting, marketing, license fees, etc)?	Incentive fees equivalent to a percentage of gross operating profit. It is not uncommon to have scaled incentive fees. Other fees and charges can include the costs of reservations systems, sales and marketing contributions or assessments, accounting charges, purchasing costs and license or franchise fees. These fees are often set as a percentage of rooms revenue.
What percentage of gross revenue is commonly set aside as FF&E reserve?	2–4%—often the percentage increases through the term of the agreement.
Is an operator guarantee common in your jurisdiction?	No—operators are very loathe to give these.
What performance measures are commonly used in your jurisdiction?	RevPAR is gross revenue divided by the average number of rentable rooms. GOP—if GOP falls below a percentage of the GOP specified in a business plan for, usually, 2–3 consecutive years, then the owner may have a right to terminate. RevPAR Index—if RevPAR of hotel falls below a specified percentage of the RevPAR of competitive hotels.
Is it usual to have a non-compete clause, e.g. that no other property with that brand can open within a certain radius?	It is fairly common though these will be subject to legislation preventing anti-competitive practices.
In your country, does the balance of power lie more with the owner or the operator?	Definitely the operator. Operators generally require owners to use contractual documents they have prepared and are not happy to move far from traditional models. The power balance will of course also depend on location and the desirability of the location.
Does the HMA give lease rights?	Typically no. A separate lease is normally in place but it is a moot point as to whether an HMA can in certain circumstances create a lease.
Is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?	Yes though banks are increasingly resisting the provision of NDAs.

IMPACT OF PROPOSED PLANNING REFORM ON THE DANISH HOTEL MARKET

MICHAEL NEUMANN, HORTEN, COPENHAGEN

An amendment to the Danish Planning Act has repeatedly been discussed between the various political parties in the Danish parliament. Earlier this year, the government proposed some reforms to the Danish Planning Act to make it possible for municipalities to allow the construction of buildings nearer to the coastline. If the bill is adopted, it could make the hotel sector more attractive to developers and hotel chains and attract further investment in an already booming Danish hotel market.

Current legislation

The Protection of Nature Act and the Planning Act limit the opportunities to build near the coastline. The Protection of Nature Act prohibits any changes that will affect the beaches, or other areas situated between the coastline and the beach protection line. Case law on this matter is very strict—even erecting a fence is prohibited in these areas.

As a general rule, the beach protection line runs parallel to the coastline 100m back in areas where summer houses have been developed and 300m back in all other areas. There are only a few exceptions to this rule, such as minor maintenance work to buildings that are already exempt, including, for example, the replacement of windows and works for agricultural purposes. In exceptional cases, the Danish Nature Agency can grant an exemption from the restriction, but only if special circumstances apply and not if the building can be situated behind the beach protection line, even if this results in a higher cost. However, particular beneficial purposes can justify an exemption.

According to the Danish Planning Act the coastal zone, which is established between 300m and 3,000m from the coastline, must "be kept as free as possible from development and installations that do not need to be located near the coast". Consequently, both sets of rules restrict the building of hotels or holiday homes near the coastline. Any greater rights of access to build near the coastline will require an amendment of one or both Acts.

Bill

An amendment which would allow increased development was proposed in the Danish parliament earlier this year. The bill would have the effect of making the provisions of the Danish Planning Act less stringent. It suggests that the beach protection line should only apply to areas with a "continuous nature". The term is not clearly defined in the bill, but it is likely to cover areas which are designated by the municipalities to be in special need of protection. It is also proposed that the rules affecting the coastal zone should be replaced by the rules affecting rural zones. The consequences of this change are not yet known. However, it is expected to increase the ability of municipalities to permit buildings near the coastline, and consequently, to make it easier to obtain permission to build in these areas, particularly if the projects can attract tourists.

In June 2015, the government restated its intention to reform the Planning Act so as to give the municipalities more freedom to use the land within the beach protection line and the coastal zones. The new Minister of Business and Growth has stated that the Planning Act needs to be more flexible. However, the Minister went on to say that such flexibility will be limited, and works or buildings directly on the coastline will probably not be allowed.

Mixed reviews

The bill has met with by mixed reviews. The President of the Danish Society for Nature Conservation has expressed a fear of hotels being built on the beaches and of themed water parks being established on the coastline if the

> "The reforms are expected to have a significant impact in Denmark, particularly on the hotel market."

Planning Act is reformed. He has also expressed his fear of letting free market forces design Danish nature, which, he believes, will impede nature's ability to design itself.

On the other hand, the National Association for Building welcomes the proposed reforms giving the municipalities an increased opportunity to create a planning policy that fits local needs. It also believes the reforms would open up further possibilities for greater business development.

Impact on Danish hotel market

Despite the varying responses to the proposals, the bill is likely to be passed and the reforms are expected to have a significant impact in Denmark, particularly on the hotel market. The conversation in the market right now is about how much of an effect the opportunity to build hotels and holiday homes nearer to the coastline will have.

As with the rest of Europe, in Denmark the hotel market is growing and, according to Statistics Denmark, there has been an increase in the number of overnight stays of approximately one million from 2013 to 2014 for hotels with more than 40 beds. The greatest increase in overnight stays has been in the Copenhagen area, but a reform of the Planning Act could mean an increase in the number of stays in other parts of Denmark as well—with its numerous islands and indentations the country has a lot of coastline.

It is anticipated therefore that the proposed reforms will encourage developers and hotel chains, offering significant new opportunities to develop hotels and holiday homes nearer to the coast and, consequently, adding fuel to an already booming hotel market.

Horten is DLA Piper's focus firm in Denmark.

NEGOTIATING THE RENT ON RENEWAL OF A HOTEL LEASE IN FRANCE

ANTOINE MERCIER, PARIS

Introduction

When a hotel owner wants to exclude any liability (employment, insolvency, tax, etc) arising from the running of a hotel in France or/and when a hotel operator wishes to become the owner of the business it operates, the parties usually decide to enter into a commercial lease. Commercial leases must be for a term of at least nine years under French law and in practice will often be for 12 to 15 years. Problems arise where the parties fail to make express provision for how the rent is to be reviewed, or calculated on renewal of the lease.

Don't let the expert decide

Under the joint provisions of Articles L 145-36 and R 145-10 of the French Commercial Code, the rent payable on renewal of a commercial lease for sole purpose premises (*locaux monovalents*), such as hotels, is not capped at the figure indicated by the last available construction cost index (*indice INSEE du coût de la construction*) but must be set according to the fair rental value of the leased premises. Unless the parties provide otherwise in the initial lease agreement, or reach agreement themselves on renewal of the lease, the appraisal of the rental value is to be carried out by a court-appointed expert. Under Article R 145-10, the review must be carried out using the customary methodology applicable to hotel rents (*usages observés dans la branche d'activitée déterminée*) which, for hotels in France, is known as the "hotel rent appraisal method" (*méthode hôtelière*). This method purports to determine the rental value according to a theoretical global turnover of room rentals (based on the total number of rooms in the hotel and maximum room rates), and taking into account any discounts granted by the tenant, occupancy rates, and (where relevant) works carried out within the premises.

In its decision of 4 February 2009 concerning a three-star hotel which was subject to a lease that did not provide any rent appraisal mechanism, the Paris Court of Appeal ruled that breakfast services offered by hotels are not included in the calculation of a hotel's turnover. This was surprising given that three-star hotels in France do not offer rooms for rent without the offer of breakfast services. As a consequence of this decision, there was a substantial drop in market rental values appraised

by the expert and thus a potential loss of rental income for all landlords of hotels in France when leases were renewed.

Thus, when negotiating a commercial lease of a hotel, or its renewal, landlords should ensure that all provisions relating to the basis on which the rent will be determined on renewal of the lease, are clear and unambiguous.

Agree on a methodology from the outset

Parties to a commercial lease under French law are free to agree on the level of rent to be applied on renewal of the lease. They can either (i) set out in the lease the calculation process to be followed or (ii) rely on a third party determination. In both cases, the parties should ensure that the relevant criteria are clearly determined from the outset.

Determining the rent under a pre-set formula

When the landlord is an institutional investor wishing to secure a stable return on investment over a long period of time, there is the option is to set the rent on renewal according to a formula based on the amount of the last rent under the expired lease plus an increase corresponding to the average variation (upwards only) of the rent according to indexation over, say, the preceding three years. However, this formula does not allow the landlord to benefit from any variation of the market rental value of premises beyond this threshold.

Therefore, the alternative is to provide in the lease that the annual rent is to be set according to a fixed percentage of the fair market value of the leased premises to be assessed at the time of the renewal by a third party expert. In this way, the rent will correspond to the yield expected by the landlord.

Ultimately, the parties may agree to set the rent on renewal at the higher of the above amounts or weigh one against another, which they are also free to do under French law. In any case, the lease should provide that the rent on renewal will not be lower than the rent under the expired lease.

Determining the methodology and criteria to be used by a third party expert

When either the tenant or the operator does not agree on the above criteria, then the lease should allow for a third party expert to be appointed by pre-set criteria.

As explained earlier, if the commercial lease does not make express provision for how the rent is to be determined on renewal or merely refers to third party expert determination without further guidelines, the result will be uncertain, particularly given the unpredictable nature of changes that may be made to the hotel rent appraisal method.

It is therefore crucial for the hotel owner to ensure that the lease provides binding criteria as to (i) the way in which the market rental value will be appraised, (ii) particular features of the leased premises and/or of the expired lease, and (iii) how the third party expert will carry out its task.

Regarding the criteria used for the appraisal of the rental market value, the lease should specify that the comparison data should relate only to rents (a) freely negotiated by the parties on renewal of a lease and not determined by a court (whose decisions usually result in lower rents), (b) agreed in the previous two years, (c) for comparable premises in terms of physical and technical features, standing, quality standards, integrated services and technologies, functionality, etc, and (d) for premises located within the same trade area as the premises currently being appraised.

Furthermore, the lease should specify the particular elements relating to the leased premises and/or of the expired rent to be taken into account such as the amount of refurbishment, improvement, renovation or extension works carried out within the premises even where such works were partly financed by the tenant/operator and/or they become the owners of the premises upon expiry of the lease. In doing so, the hotel owner should be able to secure the best level of rent.

Finally, the parties are free to provide in the lease the methodology to be used for the third party expert appraisal. In particular, it is advisable to provide that the expert a) be appointed by mutual agreement of the parties, and b) not have worked for either of the parties in recent years. The appointment mechanism should also provide that, where the parties fail to agree on an expert, a formal request should be made to the President of the relevant civil court to appoint an expert from the approved list of chartered real estate experts whose determination will be final and binding upon the parties with no prospect of appeal.

“When negotiating a commercial lease of a hotel, or its renewal, landlords should ensure that all provisions relating to determination of rent are clear and unambiguous.”

CONVERTING AN OFFICE BUILDING INTO A HOTEL IN FRANCE—LEGAL CONSTRAINTS AND PROCESS

CHRISTINE BARNARDO AND FRANCK DENIS, PARIS

Considering the lack of available construction land in French urban areas, and especially in the Paris region, the creation of new hotels now often results from the conversion of existing buildings, including office buildings.

In order to proceed with this sort of conversion, at an early stage project owners must identify the relevant legal constraints and the process to be followed in order to take these constraints into account.

Identifying the legal and administrative constraints

Constraints resulting from town planning regulations

The development of a hotel in a former office building must be authorized under the mandatory town planning rules. This authorization takes the form of a building permit issued by the local authorities.

In order to benefit from such an authorization, the conversion project must comply with the local town planning regulations (*plan local d'urbanisme*) and the various public easements (including those relating to natural hazards, historical listed buildings etc). It is also necessary to check whether the site of the development is located within a specific planning zone (*zone d'aménagement concerté*), in which case the applicable regulations may limit the potential rights to build and the potential use of the building.

The first verification required is to make sure that the change of use from offices to hotel is permitted by the relevant regulations, but it is also necessary to check that the other potential constraints resulting from these regulations do not adversely impact the project. For instance, these regulations often provide for a minimum number of parking spaces to be included in development project and the number may differ from one use to another.

Apart from these public law issues, additional constraints may result from land division regulations (*cahier des charges de lotissement*), co-ownership regulations (*règlements de copropriété*) or private law easements granted to nearby properties. Even if these private law provisions may not directly affect the issuance of a building permit application, the project owner must comply with them, as a breach may result in private law sanctions that may go as far as the demolition of the project works.

Constraints resulting from construction regulations

Apart from town planning regulations, the development of a hotel in an existing building is subject to construction regulations.

Hotels are considered by French law to be "public access buildings" (*etablissements recevant du public*) and are subject to specific administrative authorizations and regulations. These regulations are twofold: the first set provides covers fire safety, and the second access for the disabled. For both types of regulations, the project owner may be able to obtain derogations to some of the rules, subject to certain conditions.

If the hotel is developed in a high rise building (*immeuble de grande hauteur*), specific safety regulations must also be complied with.

Other constraints and authorizations required

Depending on the specific characteristics of the project, other administrative authorizations may be necessary. Thus, an authorization to occupy public land needs to be obtained in order to create a terrace on that public land.

If alcoholic beverages are to be sold within the hotel, a specific administrative permit must be purchased and transferred to the site.

It should also be noted that there are several sets of criteria that must be met by the project in order to qualify for an official French star ranking. These stars are awarded by a specific institution (the *GIE Atout France*).

Conversion process

Applications for authorization

The content of the application files for the relevant administrative authorizations is generally defined by law. Extreme care should be taken in complying with the legal requirements of making such an application, otherwise the application may be rejected or subsequently be reversed by the court in the event of a challenge by a third party.

In order to limit the risks of litigation that are inherent in town planning authorizations such as a building permit, a review of the application files by specialized legal counsel before filing is strongly recommended. Such a review will confirm the completeness of the application files and the compliance of the project with the relevant regulations can be checked.

Once obtained, the administrative authorizations, particularly the building permit, may be subject to challenge by third parties (such as adjoining owners) seeking to have them reversed within two months from the time they are made public. The administrative authorities themselves have a limited period of time to withdraw administrative authorizations (three months from the issuance of the authorization) or to challenge them (two months from the notification of the administrative authorization to the Prefect).

The actual implementation of a hotel project therefore cannot proceed until the time period during which a third party challenge, administrative challenge or withdrawal can take place has lapsed or, in the case of a third party challenge or an administrative challenge, until a final court decision rejecting such challenge has been obtained.

Carrying out the works

The works necessary to implement the project generally take place after the final administrative authorizations, free from any challenge or withdrawal right.

Additional specific authorizations may be necessary for the site itself, if the works are located on public land or if a temporary interruption of road traffic is necessary.

If the project is subject to modifications during the course of the works, it may be necessary to adapt the administrative authorizations, usually by obtaining a modifying building permit.

Completion of the works and opening to the public

Completion of the works gives rise to a formal statement of completion and compliance. The local authorities have five months from the receipt of this statement to check whether the construction works comply with the building permit.

Finally, the project owner needs to deal with the formalities for the opening of the hotel by applying to the local authorities for authorization to open the premises to the public. This authorization will only be issued after a visit to the site by the administrative commission for safety and accessibility, who will check that the project complies with the regulations relating to public access buildings and, if applicable, to high rise buildings.

THE GERMAN APPROACH TO HOTEL OPERATING CONTRACTS

MARTIN HALLER AND MANUEL INDLEKOFER, MUNICH

Management, lease and hybrid structures

Hotel operation and management is an integral issue which concerns investors in a key sub-sector of the real estate market. It is estimated that, in 2015, turnover of the German hotel industry will be EUR 29.2 billion. Additionally, the sector employs more than 480,000 people. However, the business of operating a hotel has materially changed. A few decades ago most hotels were owner-operated, but today global firms such as Accor, Best Western or Intercontinental, have entered the German market. This change in structure has also led to a revision of hotel management contract law in Germany, which we will discuss in this article.

Despite the fact that in the international context standard market practice is to use a hotel management agreement, in Germany, the most common approach for hotel operations has been to adopt a lease agreement (*Pacht*). Yet, in recent years, hybrid structures have appeared that merge elements of standard hotel management agreements and *Pacht*. These try to combine and balance out the pros and cons of both approaches.

The German *Pacht*

The *Pacht* is a statutory set of rules based on the German standard lease agreement but modified in various respects (see sections 581 to 597 of the German Civil Code). The most important modification is that the lessee is not only given possession of the premises (*usus*) but also the right to derive any profits from the premises (*fructus*). For example, if a meadow is leased with several apple trees on it, the lessee is allowed to use that land. If the lessee has entered into a *Pacht* agreement, it can also lawfully harvest the apples.

Of course it is more difficult to apply these concepts to the modern context of a hotel rather than a meadow, but the concept remains unchanged—German jurists distinguish between a standard lease and *Pacht* by looking at the purpose of the contract. If the main purpose of the contract is to transfer the right to possess the premises, it is classified as a lease contract. This is typically the case when hotel premises are not provided with installations or fixtures. If, on the other hand, the hotel premises are fully equipped for the lessee's business and ready for operation as a hotel, it is a *Pacht* agreement, since the lessee profits from the premises beyond mere possession.

Typical elements of a *Pacht*

Besides the location and additional characteristics of the hotel premises (for example that it can be described as an international first class hotel), one of the key elements of a *Pacht* is the rent. Usually the rent is fixed and calculated per room. What is also customary, is an indexation of the rent equal to 60 to 80 per cent of the actual change in the consumer price index. The standard term for the *Pacht* agreement is between 10 and 20 years, excluding break or extension options. Within the exclusively used spaces, most of the obligations to maintain and repair are the responsibility of the lessee. Of increasing importance is an "operational framework": As the lessor has no statutory rights to influence the operation of the hotel, many create a legally binding operational framework which incorporates issues such as the name of the hotel, its brand, corporate identity, marketing, etc. The lessor is responsible for furniture, fixtures and equipment (FF&E) in hotel *Pacht* agreements.

Commercial aspects of the *Pacht*

In commercial terms, a *Pacht* is similar to a lease. The lessee pays a monthly rent, which ensures a steady income for the lessor but the lessor has little influence on the actual business operation. The lessor only bears the risk of the lessee becoming insolvent. Of course this is a simplified version of the agreements that can be found in day-to-day business in Germany. There are agreements with a fixed rent and others with a turnover rent. Those with a fixed rent may include flexible elements which are profit- or turnover-based. Those with a turnover rent may include a minimum rent.

Comparing *Pacht* and management agreements

With a management agreement the owner and/or investors pay(s) the manager to operate the hotel. With a *Pacht*, the manager as *Pächter* (lessee) pays the owner and/or investor to operate the hotel. Looking at the operating risk, this has the following consequences: from a hotel manager's perspective a *Pacht* offers more opportunities and risks than a management agreement. From an owner's perspective a management agreement offers more opportunities and risks than a *Pacht*.

New trend: hybrid agreements

As mentioned above, in fact most of the agreements that are found in the market are more complex. A recent trend which seems likely to become standard practice in the future are "hybrid" agreements: *Pacht* agreements that include elements of management agreements and management agreements that include elements of *Pacht*.

The aim and purpose of such hybrid agreements is to combine the advantages and disadvantages of both approaches within one agreement, ie to balance the opposing interests of security and risk between the owner of the property (lessor) and the hotel operator (lessee). In this way, the parties can specifically agree on the distribution of operating risk. Typical clauses in a hybrid agreement for a first class hotel include, for example, the following:

- legal responsibility on the lessor to provide FF&E, although in some cases the lessee procures the FF&E within a budget provided by the lessor;
- responsibility on the lessee to maintain and repair the FF&E;
- when the agreement is terminated, the FF&E becomes property of the lessee.
- a reserve fund is set up for FF&E;
- the lessor agree not to compete with the lessee within a given territory;
- staff employed by the lessee, including a right of co-determination for the director of hotel;
- turnover rent and minimum rent; and
- non-disturbance agreement binding the lessor.

Future development

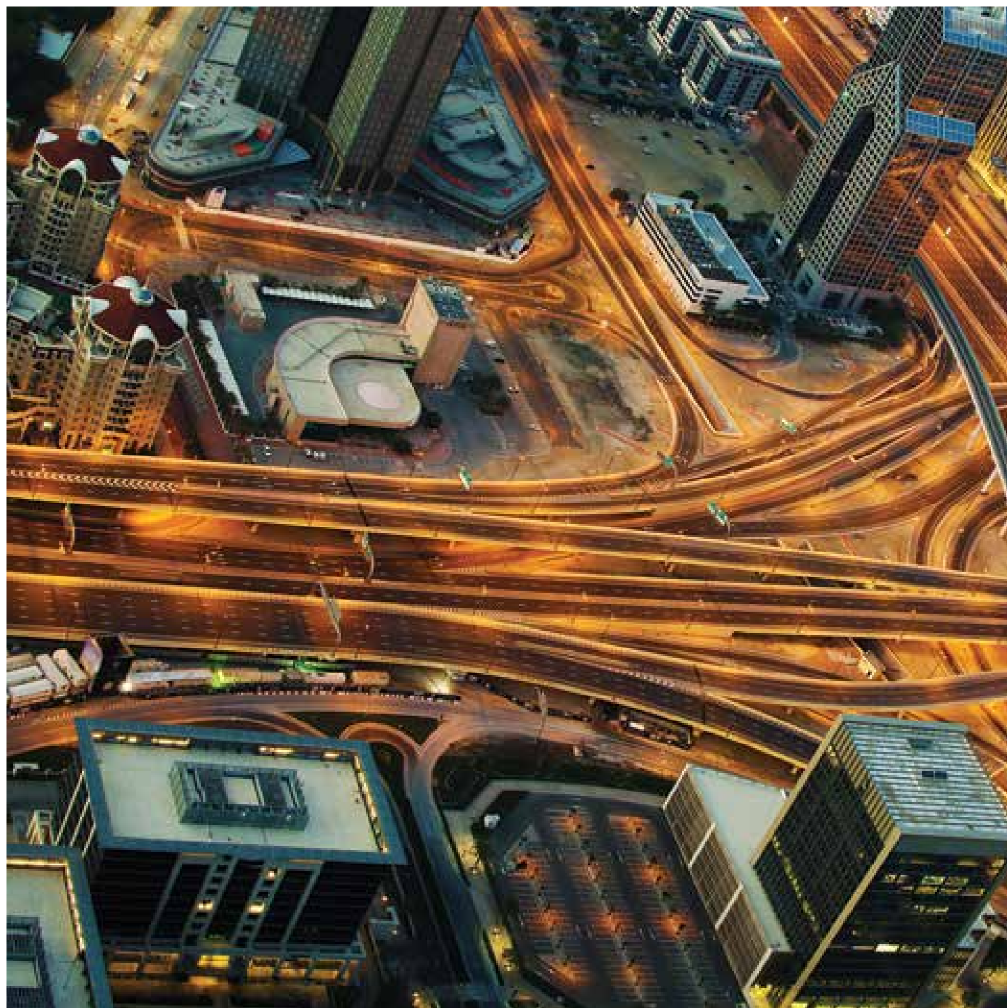
As most German hotels are owned by families, German banks or investors, it is unlikely that the traditional *Pacht* will disappear in the near future, as it provides more security for the owner. But the proportion of international investors and hotel chains involved in the market is growing. A more pluralistic market—with *Pacht*, management agreements, hybrid agreements and other types of hotel operating contracts side by side, including franchise arrangements and license agreements—can be expected to develop.

THE RISE OF LESSOR NON-DISTURBANCE AGREEMENTS IN HOTEL OWNERSHIP STRUCTURES IN DUBAI

HELEN HANGARI, DUBAI

With some of the highest RevPAR (revenue per available room) figures and occupancy rates in the world, Dubai continues to be an attractive location for hotel developers. The rapid pace at which the market is evolving however and the nature of the hotel ownership structures in place, have given rise to several issues that developers and other sector participants need to be aware of when seeking to establish or operate in the region.

In this article we explore the rise of the Lessor's Non-Disturbance Agreements (Lessor NDA). To set the scene however, we first take a look at the hotel ownership structures that give rise to these.



A quick lesson in hotel ownership structures in Dubai—PropCos and OpCos

Due to local laws and regulations, there is an increasing trend for hotel developers to establish "PropCo/OpCo" structures. Under these structures, the property holding company (PropCo) acquires the site and enters into a hotel management agreement (HMA) with a hotel operator, later granting a long lease of the hotel to the operating company (OpCo) in order to comply with local laws and regulations, in particular relating to obtaining and maintaining the necessary permits.

Land ownership by persons who are not nationals of a Gulf Cooperation Council state (non-GCC nationals), or companies with some or all of its shares being held by a non-GCC national, is restricted to certain areas of Dubai referred to as "designated areas". Within designated areas, the only type of offshore company that can be registered as the owner of real estate is a Jebel Ali Free Zone (JAFZ) offshore company. Using a JAFZ offshore company permits 100 per cent of the shares to be held by non-GCC nationals. It is also relatively simple to incorporate with relatively low maintenance costs, making it a popular vehicle for site acquisitions. Developers therefore frequently opt for a JAFZ offshore company to hold the title to the site.

However, a JAFZ offshore company cannot obtain the necessary permits for operating hotels in Dubai (for example, the hotel operating permit from the Dubai Tourism and Marketing Commerce, a permit to sell liquor from the police department or a visa for the employment of hotel staff) and therefore

> "The only remedy for a breach of the Lessor NDA would be damages."

a local OpCo must also be established, usually a local limited liability company.

Issues arising from PropCo's grant of a lease to the OpCo

The PropCo commonly grants a long lease of the hotel to the OpCo, usually when construction is almost completed and operating permits etc, can be applied for. Upon such a lease being granted, the PropCo then novates its rights and obligations under the HMA to the OpCo. Operators need to ensure that they are happy with the terms of the proposed lease to OpCo prior to giving their consent to novating the HMA to OpCo. Of the utmost importance is that the proposed lease is for a sufficient duration to cover the operating term and any renewals.

In Dubai, the grant of the lease gives rise to an additional consideration as leases with a term of 10 years or greater need to be registered at Dubai Land Department, for which a fee of 4 per cent of the "total value of the rent contract" will be payable. Although registration is mandatory, having to pay a potentially considerable fee does often cause a developer to either not register the lease or to insist on granting a lease of less than 10 years which can then be renewed. In the case of non-registration, a strict reading of the applicable law renders the lease void and it is not yet clear whether a lease of less than 10 years which has automatic renewals would be treated as being for a term greater than 10 years and therefore subject to registration at the Dubai Land Department.

Therefore, the use of a PropCo/OpCo structure leaves the operator with an "owner", under the HMA, which has a leasehold interest, which may be vulnerable to termination or being declared void, and which (as a special purpose vehicle) does not own any assets.

Enter the Lessor NDA

In the scenario outlined above, international hotel operators frequently require the parties (PropCo and OpCo) to enter into a Lessor NDA directly with the operator. A Lessor NDA requires the PrOpCo to essentially "step-into" the HMA if ever the long lease to the OpCo is terminated, declared void etc.

The terms of the Lessor's NDA should include: (a) a direct covenant from the PropCo to the operator not to terminate the lease during the operating term under the HMA, and (b) if the lease is terminated, declared void or otherwise comes to an end before the expiry of the operating term under the HMA, the PropCo agrees to take a novation of the HMA.

Lessor NDAs provide operators with comfort that the HMA will run for its full term notwithstanding the leasehold structure put in place by the PropCo. However, although this offers the operator contractual protection, it is important to bear in mind that if the PropCo ever refuses to take a novation of the HMA in circumstances which, pursuant to the terms of the Lessor's NDA, it is required to, the operator would not be able to obtain an order for specific performance from the local courts as this is an equitable remedy which is not available under the civil law system of the United Arab Emirates. This applies equally to injunctive relief, meaning that an operator will not be able to apply for an injunction to prevent the PropCo from terminating the lease.

Therefore, the only remedy for a breach of the Lessor NDA would be damages. The value of the Lessor NDA arises from the lessor providing the operator with direct contractual obligations from the PropCo, rather than the OpCo which is unlikely to hold any assets. This allows the operator to pursue the PropCo (which owns the hotel and will hold bank accounts) for damages.

INTERNATIONAL INVESTMENT IN PORTUGAL'S HOSPITALITY INDUSTRY

LUÍS FILIPE CARVALHO AND JOÃO FITAS, ABBC LAW FIRM, LISBON

Strategic measures to promote tourism, adopted in recent years as a reaction to crises in real estate, are the basis for the Portuguese government's flagship initiative for encouraging growth and diversification in investments and promoting Portuguese economic recovery.

Along with measures that benefit investment, the current state of the market—with its low interest rates—makes this type of investment one of the most secure and attractive, especially if market developments and trends are viewed as being likely to follow a pattern which will ultimately lead to the recovery of the real estate market, as has been the case in the past.

Although access to credit has been limited in the last couple of years, certain initiatives to encourage investment have been developed and implemented, such as the granting of visas to those who carry on an investment activity, commonly known as the Golden Visa regime, which allows non-EU citizens to apply for a residency permit, whenever certain conditions are met, including a minimum threshold investment of EUR 500,000. Additionally, tax reforms around Europe have made Portugal an attractive option for investors aiming to benefit from the non-resident tax regime. Furthermore, in 2015, significant changes were made to the taxation scheme for collective investment entities, including real estate investment funds (REIFs) incorporated as corporate funds or as contractual funds. Under Decree-Law no. 7/2015, of 13 January 2015, non-resident investors are subject to a flat rate withholding tax of 10 per cent on income from REIFs or resulting from redemptions. The remaining income obtained by non-residents via REIFs

investments is taxed separately, also at a flat rate of 10 per cent. However, this flat rate does not apply if the non-resident entities are offshore-based or if more than 25 per cent is owned, directly or indirectly, by other entities which are tax resident in Portugal.

Considering the above scenario and the current state of the market, investment in real estate during 2015 is expected to reach EUR one billion, being 95 per cent of the value of investment by foreign investors. Economic growth in Portugal is expected to increase to 1.7 per cent, according to the Bank of Portugal's forecasts.

Apart from real estate, tourism continues to break records and the major Portuguese cities of Lisbon and Oporto attract more visitors than ever. The international reputation of some Portuguese cities and regions is now extending beyond residential development, increasing the demand for opportunities in tourism, especially, in the hospitality and leisure sector. Based on Portugal's current political and financial stability after years of reforms and the fact that tourism investment allows investors to attract income through other markets beyond Portugal, a bet on real estate may be considered to be a low risk investment.

2014 was a record year, with revenue of EUR 10 billion being generated from abroad. At the end of the year 2,048 tourist establishments were registered and operating in Portugal, totalling 309,195 rooms. Even so it is expected that an additional 58 new tourist units will come into operation, ranging between three and five star hotels.

Up to May 2015, there was a significant growth in the numbers of hotel guests, with an increase of 8.3 per cent when compared to the previous year. This trend is also evident when looking at total income, which registers an increase of 10.4 per cent. Consequently, the average room price is also higher than last year.

The majority of tourists visiting Portugal have always been from Spain, France, the United Kingdom and Germany. Recently Portugal has become an attractive country for other European and non-European tourists. That change has also affected the trends in investment. A particular increase in interest from American real estate and private equity funds is identifiable, focusing not only on Lisbon but also on other regions, such as the Algarve and Oporto.

Besides traditional hospitality and leisure offerings, one of the most successful new trends in the main cities in Portugal is connected with short-stay accommodation, for periods up to 30 days, under the new regime for local lodging establishments, approved by Decree no. 128/2014 and further amended by Decree no. 63/2015.

The expression "local accommodation establishments" refers to entities that provide temporary accommodation services to tourists in compliance with the legal requirements. Local accommodation establishments can be set up in a house, an apartment or in hosting facilities, usually known "*hostels*".

Currently, the total number of registrations for local lodging establishments is around 17,000, but the number has been growing since the new regime came into force and may be considered to be a new area of opportunity, requiring low investment in terms of facilities and compliance, as the establishments are not subject to all of the rules and regulations applying to hotels and other types of accommodation, as normally defined.

In general terms, expectations are high and Tourism of Portugal has issued some guidelines to promote and reinforce sustainability and competitiveness in tourism in order to distinguish the different types of products launched to the large number of visitors who are expected to visit Portugal in the next few years.

"Tourism continues to break records and the major Portuguese cities of Lisbon and Oporto attract more visitors than ever."

FIRE SAFETY IN HOTELS

FLORIN TINEGHE AND FLORINA TOMA, BUCHAREST

Background to the fire permit procedure

Historically, the Romanian fire safety authorities did not enforce compliance by hotel buildings with fire safety regulations with any great energy. Recently, however, fire safety inspections performed by the authorities have started to increase in number considerably, as the authorities are interpreting the relevant legal provisions more strictly. These provisions are intrinsically linked to the construction and building authorization process. Fire safety authorities have inspected several hotels across Romania and applied sanctions for non-compliance with mandatory requirements. This approach is likely to continue in the near future.

In order to be operated legally, fire safety legislation requires a fire permit for buildings designated for use as tourist accommodation with more than three rooms or which sleep more than six people. Thus, buildings intended for use as hotels must have a valid fire permit in place. Throughout the construction period for such buildings, a "fire endorsement" is required. However, this fire endorsement is not sufficient for operation as a hotel and does not replace the need for a fire permit.

The fire permit is an administrative document which is issued by the Emergency Situations Inspectorate (ISU) and which, following a physical inspection of a location and a review of the related documents, certifies fire safety requirements have been fulfilled. A fire permit enables the owners or operators of new buildings to open, so far as fire safety regulations are concerned.

The fire permit is issued within 30 days after the submission of complete documentation. No fees or charges are payable for the issuance of a fire endorsement and/or a fire permit.

If the ownership of the hotel changes after it is opened, the fire permit remains valid and in force. However, the fire endorsements and the fire permits are valid only if accompanied by the supporting documents on the basis of which they were issued.

Sanctions for non-compliance

Law 307/2006 (the Fire Safety Law), provides for civil, administrative, financial, disciplinary or criminal liability for the person responsible for a breach of the regulations.

Administrative sanctions

The operation of a hotel without a fire permit is prohibited and is punishable as an administrative offence with a fine ranging between RON 20,000 (approximately EUR 4,500) and RON 50,000 (approximately EUR 11,500). The responsibility for obtaining a fire permit for the building rests with the person/company owning the hotel and, in the case of companies, also with the director and manager of the company. The Fire Safety Law expressly provides that the obligation to obtain the fire permit lies with the individual or entity carrying out the construction works, or as the case may be, with the beneficiary of the investment. At the same time, in the case of companies, the director or the manager of the company has the primary responsibility to apply for and obtain a fire permit, to ensure that the relevant conditions on the basis of which the fire permit was issued are complied with and, in the event of a revocation of the fire permit, to suspend the operation and use of the hotel immediately.

If the person or entity on whom a fine has been imposed pays the fine within 48 hours of the contravention notice being issued or, as the case may be, as of the service of the notice, the minimum fine provided for by the law for each category of contravention is reduced by 50 per cent.

Suspension of operations at the hotel

The ISU inspectors are entitled to carry out inspections with regard to a hotel's fire safety compliance. If during such inspections the inspectors ascertain that a hotel or the relevant fit-out works do not comply with the conditions on the basis of which the permit has been issued, for one of the specified reasons (such as: change in designated use, alteration, addition, refurbishment or renovation of or to the building), the fire permits are deemed null and void and the owner is obliged to restart the procedure for obtaining a fire endorsement and fire permit.

Fire permits issued by the ISU can be revoked if, during the operation of the hotel or during the carrying out of fit-out works, inspectors detect a non-observance of fire safety measures or a serious breach of the specific regulations relating to: division of buildings for the purposes of passive fire protection,

the protection and safe evacuation of individuals, and the safety of the emergency services that intervene in order to extinguish the fire etc.

If such a revocation is implemented during an inspection, a suspension of operations at the hotel may be ordered. Following such a suspension, the ISU must notify the Commercial Registry, the Prefect's office and any other competent public authority of its decision within 48 hours. The decision to suspend operations can be challenged in court but this is likely to be a time-consuming and expensive process. A challenge will not automatically interrupt the application of the suspension decision.

Criminal liability

The operation of a hotel without a fire permit can, in some circumstances, trigger criminal liability for those responsible for compliance. Under the Romanian criminal law, both a legal entity and an individual can be jointly charged with criminal offences. The criminal liability may arise in the event of a fire in a hotel building which is operating without a fire permit, if the fire causes damage to assets, injury to individuals or causes the death of individuals.

Continuing operations, after the competent authorities have ordered the cessation of operations and use of the hotel due to non-compliance with fire safety regulation, is criminal in itself, and is punishable with imprisonment for a term from three months to one year, or a fine.

In the event of damage to assets (immovable or movable property) as a result of fire in a hotel where fire safety regulations were not observed, criminal liability for involuntary destruction may be triggered. If individuals are injured or die, criminal liability for involuntary injury or involuntary manslaughter may arise.

Practical aspects

Obtaining a fire permit is in practice a rather lengthy process which can take up to six months or even a year. This can cause commercial difficulties when a new hotel has been completed but cannot be operated.

Difficulties can also arise when an existing hotel is being acquired. Some hotels in Romania do not have a fire permit in place and those which have, are likely to have undergone renovation works which triggered the obligation to restart the authorization process. In order to assess the potential risks and/or the potential non-compliance of a hotel building with applicable fire safety regulations, a technical inspection of the hotel building must be carried out prior to its acquisition.

If a hotel building does not comply with mandatory fire safety regulations, the authorities can allow the owner a short period, usually between 30 and 60 days, to remedy the existing breaches in order for the hotel to operate legally. However, the process of bringing the hotel up to a compliant standard can be a costly and lengthy process, and the period allowed by the authorities is usually insufficient. By way of example, it can take around three months just to obtain the building permit for the remedial construction works required for a fire permit to be issued (for example, the construction of a new fire exit).

The risk of personal liability for the hotel company's representatives raises serious concerns and can lead to a situation where decisions made in the interests of the hotel company are not always in the best interests of its representatives.

The parties to a hotel acquisition need to ensure that the fire permit is in place and that the transactional documents include representations and warranties from the seller confirming that the hotel complies with fire safety requirements and that all permits, authorizations and approvals necessary to operate the hotel legally have been duly obtained, are valid and in force. In addition, if the respective hotel building does not have a fire permit in place, the seller should be obliged to obtain a fire permit as an essential condition precedent to closing. Depending on the details of the transaction, the costs of the authorization process and remediation works can be undertaken by the seller or perhaps shared by both parties. Only once a valid fire permit is in place, should the hotel business be transferred. A purchaser should be very cautious about undertaking hotel activity in a location where a fire permit is not in place or where there are questions about its validity. The same principles apply in the relations between hotel operators and hotel owners. Hotel operators should clearly require building owners to assure the fire safety compliance of the buildings before entering into any lease or management agreement.

COMPENSATION FOR UNILATERAL TERMINATION OF RUSSIAN HOTEL MANAGEMENT AGREEMENTS

PAVEL ELNIKOV, MOSCOW

International hotel operators have been active in the Russian hotel market for more than two decades and most of them now have a local presence in Russia with part of the management fees being paid locally. Few of them use Russian law as the governing law for their contracts, although those who do can be quite successful in penetrating the market. Owners appreciate operators' willingness to adapt to the local environment, and the possibility of working in a familiar legal background. They enjoy additional rights granted by Russian law while operators who have shown the market in this way how flexible they are, use this as a competitive advantage, gaining access to more projects, while taking the associated legal risks.

General approach

In order to ensure the longevity of the management relationship, template agreements prepared by international hotel operators provide for compensation in the event of the early termination of a management contract, usually in the form of liquidated damages. The general operators' approach is that such compensation is calculated on the basis of the amount of the management fees due to the operator for the remainder of the contract term. Some owners do not view this as a balanced approach and negotiate a lower amount, whether an absolute figure or a multiplier applied to an average of the operator's fees over the two years prior to the termination which is further reduced during the lifecycle of a contract.

Why operators avoid management contracts governed by Russian law

There are several reasons why management contracts governed by Russian law are not widely used by international hotel operators. One of them is that Russian law until recently did not protect long term relationships under services contracts. The hotel owner had a right expressly provided by law to terminate a service contract unilaterally at any time subject only to an obligation to reimburse the actual costs of the operator. Any restrictions on this right were void.

Until recently operators would describe a management contract under Russian law as a "mixed agreement" with elements of a service agreement and of an agency agreement, which, if entered into for a defined term, did not allow early termination. However, not all operators provide agency services through personnel (usually, a general manager and financial controller) officially employed by the operator and performing management services for the owner's hotel entity. Most operators leave the owner to employ the general manager and financial controller and therefore there is no standard agency concept in the relationship.

Resolution on freedom of contract

A change came in March 2014, when the Plenum of the Higher "Arbitrazh" (ie Commercial) Court of the Russian Federation issued its a resolution entitled "On freedom of contract and the limits to such freedom". This resolution was believed to change the approach regarding the termination of services contracts. The resolution expressly allows parties to terminate services agreements on the condition that an agreed sum of money is paid to the other party. However, this approach has not resulted in a unified court practice in support of compensation payments. Most subsequent court cases in fact turned out to be not very supportive of the principles of the resolution.

In addition, the resolution allowed any statutory rules in a civil relationship to be changed by agreement except for instances when such rules are imperative. Therefore,

"On 1 June 2015 amendments to the Russian Civil Code came into force which may change the practice of compensation payments in Russia."

there was scope for the right of unilateral termination to be excluded by the parties. However, the courts in fact have viewed such a provision as imperative. Therefore, neither of these revolutionary provisions have dramatically changed the attitude of the courts towards allowing unilateral termination subject to paying compensation.

Civil Code amendments

On 1 June 2015 amendments to the Russian Civil Code came into force which may change the practice of compensation payments in Russia. In accordance with Section 310, if the right of unilateral termination is set by law, the parties can agree to termination on condition that a certain sum of money is paid to the other party. This effectively repeats the principle promulgated by the Higher Arbitrazh Court, but at a legislative level. This could result in enforceable compensation payments for terminating services agreements and possibly including hotel management agreements.

As only a short period of time has passed since this provision came into force, court practice on this matter has yet to appear. Previously, courts interpreted compensation payments as a penalty and not as the compensation mentioned in the resolution "On freedom of contract and the limits on such freedom". Therefore, it is difficult to predict which route the courts will pursue. It may take some time for court practice to take shape and be applied consistently by the higher courts.

In the short term, if this new provision does not persuade other operators to use Russian law as the governing law for their management contracts, it will definitely make the position of the operators already using it much stronger. More importantly, Russian owners will hopefully be more prepared to accept the concept of long term management contracts, which will have a positive effect on the industry.

THE EVOLUTION OF HOTEL MANAGEMENT CONTRACTS IN SPAIN AFTER THE CRISIS

ALMUDENA COMIN, MADRID

Finally, Spain is coming out of the crisis. After years of uncertainty, 2014 was a record year for the Spanish hospitality sector with some 65 million tourists arriving, representing the greatest increase in the last decade. Likewise, investment in the hospitality sector grew by 37 per cent. Expectations are that in 2015 both trends will continue.

Overall confidence is returning and credit is slowly flowing back into the market. Large international hotel chains continue to show an increased appetite for the Spanish market mainly focused in the Madrid and Barcelona luxury and upscale segments and, generally, Spain still offers market opportunities for investors, although truly distressed assets are not as numerous now as they once were. Asset purchase transactions have been increasing since 2013 and, in the coming years, these acquisitions are expected to go hand in hand with new land developments as ways to penetrate the market.

These factors are likely to result in change to the balance of power between the various market players. Particularly aggressive or unbalanced management agreements or rent agreements with a fixed rent that do not include any revision mechanism which could reduce the risk of unsustainable rental levels are becoming rare. Properties will have to be carefully evaluated and properly focused, and both owners and operators are now prepared to be more flexible in finding the scheme which best provides for a balance between the return for the operator and return for the owner.

The main business models for hotel operation are: (i) self-operation of the hotel by the owner, (ii) self-operation through a franchise agreement with a hotel brand, (iii) third party operation through a management agreement with a management company or hotel brand, and (iv) a lease of the property to a hotel brand which pays rent for the building alone. All of these arrangements have become increasingly flexible and, as we have said, can now be heavily negotiated to adapt them to the specific circumstances of an individual deal.

Self-operation by owner

Self-operation is the simplest scheme: The owner of the property chooses to operate without the involvement of any middle man or operator. The owner assumes all of the risks of running the business and, consequently, will keep all of the profits if any are generated.

However ever growing international competition and the increasing dependency on online sales via third parties or through branded websites has led independent hoteliers to join in membership schemes and reservations or referral systems which provide an extended access platform for their properties and, in certain instances (for example, Leading Hotels of the World, Relais Chateaux) with something akin to brand recognition. Additionally most of them have actively joined internet platforms and social networks to profit from the international exposure and the chance to sell direct to customers to whom the internet offers access.

Franchise schemes

Traditionally, Spanish owners have wanted to be actively involved in the operation of their properties. This explains why Spain remains a market that consists of numerous independent hoteliers and operations. Owners' distrust of international chains and their management schemes, the fact that hotel chains are not inclined to sign lease agreements and that many hotel owners are not sufficiently knowledgeable about the hotel sector would explain why, since the crisis, franchise agreements have become increasingly common.

Franchise agreements allow those owners who want to be personally involved in the management of their operations to reduce their risk and position their establishment in the market under the umbrella of an established brand. Whilst the day to day operation of the business and the entire risk of the operation still fall on the franchisee, the franchise provides the owner with a license to exploit a comprehensive method of doing business developed by the franchisor in exchange for a fee based on a revenue per room basis. The franchise agreement generally

includes a right to use the intellectual property rights and the know-how of the franchisor and to receive technical and marketing assistance.

Franchisors are required by law to disclose to the franchisee in writing all of the essential terms of the franchise at least 20 days prior to the execution of any franchise agreement or the making of any payment under such an agreement. Franchisors should always seek legal and technical advice when preparing their disclosure since should their disclosure omit any of the relevant information it may be considered null and void and would also render the franchise invalid. Hence the disclosure, if not made accurately, may provide the franchisee with a means to terminate the agreement before the agreed expiry date, particularly in those cases where the franchise agreement is largely to the benefit of the franchisor.

Management contracts

A management contract is an agreement between a hotel owner and a management company under which the management company will operate the hotel for a fee. The hotel owner remains the owner of the hotel business (including the property, its assets and its employees) and undertakes all risks and expenses associated with it. The management company will manage the hotel business on an exclusive basis, making all the day to day decisions pertaining to such business without interference by the hotel owner in the daily running of the operation but subject to quality standards, in exchange for a fee.

Management contracts may be branded or non-branded. Branded management contracts will be entered into with a hotel chain that places the hotel under one of its brands. It will also entail the payment of fees for ancillary services such as technical and pre-opening services and reservation systems, and a license fee for the brand. Non-branded management contracts are those entered into with a non-branded dedicated management company that provides focused asset management services to the owner.

"Standard" management contracts no longer exist. Owners have gained more operational control and fees have evolved from standard structures, where there is a base management fee calculated as a percentage of the hotel's total revenue and an incentive management fee based on the gross operating profit after the base fee, to structures which provide for layered fees (with a base management fee and an incentive management fee based on a threshold of gross operating profits levels scaling higher as the contract progresses) or even hybrid structures where base and incentive fees are linked to a guaranteed return to the owner or subordinated to debt coverage. Owners now seek to obtain some type of operator guarantee whereby the owner will receive a certain level of profit and will be almost certainly establishing performance tests allowing the owner to terminate the contract if the operator underperforms.

Combined management and franchising contracts

The "manchise" agreement is a hybrid of a franchise agreement and a management agreement and can vary from a complete combination of both forms of agreement to one that is initially a management agreement but which, after an average of three to five years, once the operation begins to even out and mature, moves on to a franchise relationship. It is one of the solutions envisaged for hotel owners who do not want to bind themselves into long term management agreements and who ultimately want to undertake the responsibility for operating the hotel.

Management and franchising contracts may also be combined when there are three participants in the management equation ensuring some kind of leverage to the entire structure: the owner who lacks expertise and entrusts the management of the hotel to a non-branded dedicated management company acting as hotel operator and a hotel chain acting as franchisor. While the most common structure is that where the owner enters into a management contract with the operator and the operator executes a franchise agreement with the hotel chain, there is no obstacle to the owner being party to both the management contract with the operator and a franchisee under the franchise agreement, although this structure is not as common.

Leases—from property and industry leases to hybrid schemes

In recent years, pure real estate lease agreements (where the owner lets the property to the hotel company which pays a rent and assumes the entire risk of operating the hotel) and industry leases (where the entire hotel business and not just the bricks and mortar is leased) have also evolved: fixed rents with indexed growth alone are not as frequent and other arrangements, such as calculating the rent on the basis of the volume of sales or on the operating profit generated by the hotel, are becoming widely used. Both revenue based and operating profit structures may also include a base rent to be paid in all instances, thus ensuring a guaranteed return to the owner. This would be regarded as a hybrid lease which would normally include other obligations such as the need to maintain brand standards, which would be normally found in a hotel management agreement.

In the last few years, we have seen how traditional structures have kept evolving with a view to motivating all parties to continuously increase profitability while preserving the value of the hotel property. Hybrid structures have become more popular as the owners' bargaining power has increased. Bespoke solutions will have to be found for each property in a market which is becoming more and more sophisticated and where owners need to obtain advice to design the solution that best fits their interests and can be adapted to the special features of their properties.

THE RISE OF SERVICED APARTMENTS—WHERE CAN THIS GO?

LAURA PROSSER, LONDON

In recent years, the serviced apartment sub-sector of the hospitality industry has grown faster than any other class of temporary accommodation in Europe. Consumers now travel more widely and frequently, both for business and pleasure purposes. As a result, accommodation requirements are changing: customers are looking for more flexibility, more space and a "home away from home" experience.

In theory, for operators, this means an increased risk to profitability, as revenue from the asset is generated almost entirely from the guest rooms themselves rather than a significant proportion being derived from an on-site food and beverage offering. However, staffing costs are likely to be lower than those of a traditional hotel,

not only due to savings made by the absence of a restaurant but also through reduced housekeeping costs (room cleaning is unlikely to be offered more often than weekly unless a premium is paid for a more frequent service).

The combination of lower fixed costs and thus a higher proportion of revenue being converted to profit makes for a business model which is, commentators argue, potentially more attractive than a traditional hotel.

Who is investing and why?

The quality and location of the real estate involved in the best serviced apartment operations is particularly attractive. To meet consumer demands, serviced apartments must be positioned in prime locations, close to transport links and business and shopping districts in key cities. The value arises from the perceived flexibility of the assets which can be put to alternative uses, subject to the necessary planning/ zoning consents.

A number of private equity investors have entered the market energetically, injecting capital into their chosen independent brands directly. This has allowed some of the newer independent brands to own and operate their own assets, expanding their brand profile through site acquisitions in key cities across the UK and Europe.

Institutional investors have also taken notice of the sector but are perhaps more conscious of its relative infancy, taking a comparatively cautious approach to investment as compared with the more opportunistic private equity houses. Barriers to institutional investment have included a lack of brand awareness and/ or a proven operator track record, as well as a lack of understanding on the part of the investor of the sector as a whole, with some operators commenting that, in the recent past, investors have been uncertain as to whether the assets are classed as residential or commercial perhaps since, in the UK, sites acquired for development as serviced apartments were often apartment blocks authorized for planning/ zoning purposes for residential use, although serviced apartments are now accepted as hotels. This has led to many institutional investments being structured in a more risk averse manner, with sale and leaseback arrangements proving to be popular.

Sale and leaseback structures

Through a sale and leaseback structure the investor will acquire the freehold/long leasehold title to the asset, and will then grant a fixed term lease (for example, 25 or 30 years) back to the operator. Subject of course to the terms of the lease, the operator may opt to charge its lease to a third party lender for the provision of additional operating finance.

This provides the investor with reliable security as legal title to the asset is acquired at the outset, and a regular stable income over a fixed period with no exposure to the risk of an operating loss. If the operator is unable to meet the rent payments, the investor can terminate the lease and take back the asset.

For the operator, working under the remit of a lease rather than a management or franchise agreement allows it to have full control over the day to day operation of the asset. However, it will also assume full risk for any operating losses and at the same time will remain liable for the rent payments throughout the term irrespective of the success of the business. That said, if the business proves to be successful the operator will retain the whole of any surplus.

Who are the operators?

While the serviced apartment market has been well established in territories such as the United States and Australia for many years, with known branding and established operators, it is still a relatively new concept within Europe and particularly so in the UK.

The operators who are active in the market vary from a selection of established "big brands" such as Accor/ Adagio, IHG/ Staybridge Suites, to smaller independent brands, often having an emphasis on design, who are looking to offer something new to the consumer.

Whilst it would appear that the big brands prefer to remain asset light, tending to adopt the management or franchise agreement operating model, smaller independent brands without the same level of financial backing and identifiable covenant strength may have to consider alternative options depending on investor requirements.

Conclusions

While serviced apartments remain a developing sector of the market, with a lack of local comparables for benchmarking and untested brands, it seems likely that the institutions will continue to remain interested but cautious, structuring their investments accordingly. However, as more product is brought to market (such as the owner/ operated brands which have been backed by private equity investment) and the success theories of the market's supporters are tested, there may be a movement away from sale and leaseback structuring towards management and/ or franchising agreements, as has been the case in recent years for more traditional hotel operating models.

“Serviced apartments must be positioned in prime locations, close to transport links and business and shopping districts in key cities.”

CHANGES IN THE TAX REGIME APPLICABLE TO FOREIGN INVESTMENT IN AUSTRALIAN REAL ESTATE

PETER FALUDI, SYDNEY

Recently two Australian States have announced changes to the taxes imposed by them in relation to the acquisitions of real estate which will be of particular relevance to foreign investors in Australian property. Whilst one of the changes will benefit such investors, the other will increase the tax burden on foreign investors in Australian real estate.

This article provides a brief summary of the changes.

South Australia—stamp duty on transfers of non-residential real estate to be abolished

In the South Australian Budget handed down on 18 June 2015, the State Treasurer announced that stamp duty on non-residential real property transfers would be phased out completely by 30 June 2018. This is to be done by phasing out the duty starting from 1 July 2016 with a reduction of one third to occur on each of 1 July 2016, 1 July 2017 and 1 July 2018.

The phasing out will apply to both direct acquisitions of non-residential real property in South Australia and indirect acquisitions of companies or trusts that hold such real property. The Commissioner will rely on information provided by the Valuer-General (generally, land use codes for land tax purposes) to determine whether land is considered to be residential or non-residential land for stamp duty purposes.

Currently, stamp duty is imposed on transfers of land calculated by reference to the value of the land at the time of the transfer. For real estate with a value of more than $500,000, the duty is $21,330 plus $5.50 for every $100 or part thereof over $500,000. This is clearly a significant cost in relation to the acquisitions of real property. Similar duties are imposed in each other State and Territory of Australia.

Although there are a number of concessions available for certain residential properties, these are not relevant to commercial transactions. As a result, the State Government's decision to abolish the imposition of such duty as from 1 July 2018 will have a significant benefit for investors in South Australian real estate.

In addition to stamp duty on transfers, South Australia also imposes an ad valorem registration duty on transfers registered with the Land Services Department (which must occur in respect of all transfers of real estate). This fee is calculated at an amount equal to $264 plus $77.50 for every $10,000 or part thereof above $50,000. DLA Piper was recently involved in a transaction where the registration fee imposed was $2 million.

It is not clear whether, on the abolition of the transfer duty, registration duty will continue to apply. We note that the Regulations to the Real Property Act in South Australia provide that where the Commissioner of State Taxation determines that a transfer of land is exempt from stamp duty or no ad valorem stamp duty is payable, the registration fee is merely $155. Based on the current Regulations, once stamp duty is abolished completely, ad valorem registration duty should also no longer apply, although this has yet to be confirmed.

Victoria—additional stamp duty payable by foreign purchasers of residential real estate

In the Victorian Budget which was handed down earlier this year, it was announced that an additional 3 per cent duty will be payable by foreign purchasers of residential property. The legislation giving effect to the imposition of that duty was passed on 29 June 2015.

The effect of this change is that as from 1 July 2015, in addition to the normal stamp duty payable on the acquisition of real estate, an additional duty of 3 per cent of the value of the property being acquired will be payable where the real estate is residential property and is to be acquired by a foreign person. In certain circumstances, this will apply even if the foreign purchaser acquires its interest in the property by acquiring the entity which owns the property.

The duty will not apply in respect of transfers of land which are subject to contracts for sale of land entered into prior to 1 July 2015 but will apply to all purchasers or transferees of residential property in Victoria who enter into the contract, transaction, agreement or arrangement relating to the property on or after 1 July 2015. For example, if an option was entered into by an Australian purchaser prior to 1 July 2015 and subsequent to 1 July 2015, the purchaser nominates a foreign purchaser to exercise the option, the additional duty will be payable.

Who is a foreign purchaser?

In determining whether or not a person is a foreign purchaser, the following tests will apply:

- in the case of a foreign natural person, whether the person is or is not an Australian or New Zealand citizen or permanent visa holder;
- in the case of a foreign corporation, whether it is incorporated outside Australia or, if incorporated inside Australia, whether a foreign person has a controlling interest in that company; and
- in the case of a foreign trust, whether a foreign person has a substantial interest in the trust.

A controlling interest in a foreign corporation requires there to be a foreign person (whether alone or together with any associated person) to be in a position or potential position to control more than 50 per cent of the voting power of the corporation or has an interest in more than 50 per cent of the issued shares in the corporation. The Victorian Commissioner of Stamp Duties also has a discretion to deem a foreign person to have a controlling interest in a company where that person has direct or indirect influence on the outcome of decisions.

In respect of whether or not a foreign person has a substantial interest in a trust, this will be determined by reference to whether or not a foreign person (either alone or together with any associated person) has a beneficial interest of more than 50 per cent of the capital of the trust. The Commissioner has a similar discretion to determine whether a foreign person has such a substantial interest where he is of the view that the person has direct or indirect influence on the outcome of decisions.

What constitutes residential property?

The term "residential property" is not limited to a single dwelling but applies to:

- land that has a building on it that is designed and constructed solely or primarily for residential purposes and may be lawfully used as a place of residence;
- land on which a foreign purchaser intends to construct a building solely or primarily for residential purposes and may be lawfully used as a place of residence; and
- a company or trust which owns residential property where the foreign person acquires a 50 per cent interest or more in a private company or a 20 per cent or more interest in a unit trust.

Will the new provisions affect developers?

To the extent that a foreign purchaser acquires land which may not have been residential previously but will be re zoned as residential and on which a residential development is to be built, the additional duty will be payable. The legislation provides that should a foreign person acquire a non-residential property and later change its intention to use the property as a residential property, the foreign person must lodge a statement with the Commissioner within 14 days of forming the relevant intention with liability for payment arising within 30 days of the intention being formed.

Where a foreign person is involved in a joint venture with a local developer, careful consideration needs to be given as to whether or not the joint venture can be classified as a foreign person for the purposes of the new provisions thereby triggering the obligation to pay the additional duty.

If property is acquired for both residential and commercial purposes, if the primary use of the property is to be for residential purposes, the property will continue to be regarded as residential property and the additional duty will be applied to the value of the whole property, including the parts that are not to be used for residential purposes.

The Victorian Treasurer has a discretion to relieve foreign persons from the imposition of this duty but such relief is entirely at the discretion of the Treasurer. Guidelines have been issued as to what the Treasurer will take into account in determining whether or not to grant such relief for foreign property developers. Generally speaking it is intended for the relief to apply to those whose commercial activities add to the supply of housing stock in Victoria.

Impact on transactions

Notwithstanding the Treasurer's discretion to relieve foreign persons from the imposition of the new duty, this is clearly a significant impost on foreign purchasers. The normal transfer stamp duty is calculated at the rate of 5.5 per cent of the taxable value of property valued at more than $960,000. Accordingly, for residential properties valued at more than this amount, the above change has the effect of increasing the duty payable by foreign purchasers to 8.5 per cent, constituting an almost 54.5 per cent increase in duty payable.

REAL ESTATE ACQUISITIONS IN JAPAN

LANCE MILLER AND MAKIKO KAWAMURA, TOKYO

Introduction

Japanese real estate is becoming a more attractive market for international investors. There are a number of different investment structures for foreign investors, some of which are unique to Japan with no equivalent in other developed legal systems.

Interest in acquiring Japanese real estate, such as hotels, office buildings and retail complexes, is increasing due to Abenomics (the name given to the economic policies advocated by Prime Minister Shinzo Abe since the December 2012 general election) and the depreciation of the yen against major currencies. Japan expects to have a robust real estate market at least through to the 2020 Olympics.

This article briefly outlines the most common investment structures considered by foreign investors wishing to acquire Japanese real estate. Each structure has different tax consequences for the investor so it is important to consult a tax specialist on each specific transaction. Some structures discussed below, particularly the "TMK" and the "GK-TK", are unique to Japan, and there are no perfectly analogous structures in other developed legal systems.

1. Direct acquisition

Overview

In a direct acquisition, an offshore foreign investor directly or through an offshore special purpose company (SPC) acquires the target property or beneficial property interest in Japan. Generally speaking, there are no restrictions on foreign direct investment for real estate investment in Japan and direct offshore acquisitions by investors or SPCs are common.

Incorporation and governance

Since the investor or SPC is located offshore, neither incorporation of an on-shore acquisition entity in Japan nor Japanese laws regarding governance of Japanese legal entities are applicable.

Tax

When the offshore acquisition entity or investor receives income from the property or real estate beneficial interest (for example, rental income (except when the lessee is an individual and the property is used by the lessee or his/her relatives)), the income will be subject to withholding tax on payments determined in accordance with the applicable tax treaty between the offshore acquirer's home jurisdiction and Japan. In addition, capital gains from the sale of real estate or beneficial interests in Japan will be subject to withholding tax at a rate of

> There are a number of different investment structures for foreign investors, some of which are unique to Japan with no equivalent in other developed legal systems.

10.21 per cent to the extent a purchaser has a withholding obligation (for example, a Japanese entity). Capital gains tax is also applicable and the current rate is 25.5 per cent for an offshore entity even without a permanent establishment (PE). The Japan–US tax treaty does not provide an exemption for capital gains in Japan, and capital gains tax is generally speaking not subject to exemptions under the applicable tax treaty with the home jurisdiction of the seller.

The offshore entity is required to file a notice with the Japanese National Tax Agency (NTA) within two months from the sale as well as a tax return to declare the capital gains within two months from the end of the fiscal year of the offshore entity. Separately, the acquisition of property or beneficial interests in property located in Japan by an offshore operator creates a potential risk of creating a PE. If the offshore investor creates a PE in Japan, it will be subject to ordinary corporate tax at a rate of 35.64 per cent on its net income. While acquisition of real estate in and of itself does not necessarily create a PE, since it is common to hire asset managers and the investor may be receiving ongoing payments from its holdings in Japan, the risk of creating a PE may be heightened. For this reason, many acquirers prefer to use an alternative structure to avoid the PE risk when acquiring property or property interests in Japan.

2. *Tokutei mokuteki kaisha* (TMK)

Overview

A *tokutei mokuteki kaisha* (TMK) is a special purpose limited liability company that was introduced in 1998 and can only be used for securitization of assets. Property rights can be securitized by a TMK through the issue of asset-backed securities (*shisan taio shoken*) to investors, usually in the form of equities or bonds. Profits are distributed to investors by way of dividends on equities or interest on bonds, depending on the nature of the security issued to investors by the TMK.

Incorporation of TMK; filings for acquisition of assets

Because of its special role as an investment vehicle for securitized assets and preferential tax features, TMKs are subject to stringent regulatory requirements. In order for a TMK to acquire the target assets or to issue asset-backed securities including preferred equities (*yusen shusshi*) or specified bonds (*tokutei shasai*) (as defined and regulated by the Act

on Securitization of Assets), an asset liquidation plan (ALP) must be filed with the Financial Services Agency (FSA). An ALP should cover:

- the proposed business period of the TMK;
- the maximum number and type of the rights to be associated with the asset-backed securities and special purpose borrowings of the TMK;
- a description of the TMK's specified assets and seller, and timing of when such assets will be acquired;
- the manner in which the TMK's assets are to be managed and disposed of;
- certain matters relating to borrowings of the TMK; and
- other matters prescribed by relevant cabinet ordinances.

Any changes to the plan stipulated in an ALP must be filed with the FSA.

No minimum capital is required to establish a TMK. Because the equities or bonds issued by a TMK fall under the definition of a security in Japan's Financial Instruments and Exchange Act (FIEA), a TMK generally uses a licensed securities broker or asset management company in order to offer the equities or bonds or to manage the capital invested by investors.

A TMK may be incorporated within approximately one month. However, in order for a TMK to acquire the target assets or to issue asset-backed securities, a sufficiently detailed ALP must be filed with the FSA. In practice, it usually takes about three months for a TMK to be incorporated and ready to acquire assets.

Governance

The purpose of a TMK is limited to acting as an asset-holding and asset-disposition vehicle, and all operations and management of the TMK's assets, including solicitation for investment and management of invested capital, are generally outsourced by the TMK to outside service providers. Two types of members are permitted for a TMK:

(i) specified members, who hold specified equities (*tokutei shussi*); and

(ii) preferred equity members, who hold the preferred equities.

Specified members have voting rights and supervise the operations of the TMK. Preferred equity members have preferred rights to receive the dividends and/or distribution of residual assets though they usually have only very limited voting rights.

A TMK must have at least one director (*torishimariyaku*) and one statutory auditor (*kansayaku*) but there is no residency requirement for the director or auditor. In addition, if certain requirements are met (for example, the TMK issues preferred equities) an accounting auditor (*kaikei-kansanin*) is required. Further, a TMK is subject to several disclosure requirements regarding the TMK's assets in order to ensure investors are protected.

Tax

If a TMK is "tax qualifying" it may take a deduction against taxable income for any dividends paid to its members. This means that, in theory, if the TMK distributes all of its taxable income it will not have any income that would be subject to corporate tax. A TMK must satisfy all of the following criteria to be considered a tax-qualifying TMK:

- The TMK is properly registered in terms of the Act on Securitization of Assets;
- The TMK issues either:
  - specified bonds of 100 million yen or more through a public offering;
  - specified bonds that are expected to be held exclusively by qualified institutional investors (QIIs);
  - preferred equities that are subscribed for by 50 or more investors; or
  - preferred equities subscribed for exclusively by QIIs.
- The TMK's fiscal year may not exceed one year.
- More than 50 per cent of any preferred equities or bonds issued must be issued in Japan.

In order for a TMK to be tax qualifying (for example, dividends to be deductible against taxable income in a given fiscal year) it must satisfy all of the following conditions, among others, for that fiscal year:

- The TMK must conduct its business in accordance with its ALP and not engage in any other business or hold any assets except as specified in its ALP;
- The TMK must contract with third parties for management of the property or enters into a trust agreement with a third party trustee for management of the property; and
- The TMK must declare and pay as a dividend over 90 per cent of its "distributable profit" in that fiscal year. The "distributable profit" amount is based on income determined in accordance with JGAAP.

If the TMK does not qualify for the preferential tax treatment it will be taxed on corporate income at the effective tax rate at 35.64 per cent. In addition, distributions of profits are still subject to Japanese withholding tax at a rate of 20.42 per cent, subject to exemption or reduced withholding tax rates under applicable tax treaties.

For a real estate acquisition by a TMK, a reduced tax rate is available in respect of registration and permit tax and real estate acquisition tax. The registration tax on a real property transfer is reduced from 0.2 per cent to 0.13 per cent when a TMK acquires the property. The tax base for real estate acquisition tax is reduced to 40 per cent of the property value where the property acquisition completed by 31 March 2015.

3. *Godo kaisha* (GK)

Overview

A *godo kaisha* (GK) structure is similar to a limited liability company under US law. It allows more flexibility in regards to corporate governance and management decisions than does a TMK or a conventional corporation (*kabushiki kaisha* (KK)). The annual corporate governance requirements costs are generally lower (in comparison with a TMK or KK) as there are few formal corporate governance requirements to be observed.

Incorporation

No minimum capital is required. The GK is established by filing with the Legal Affairs Bureau and may be incorporated within approximately one month after the executed incorporation documents are received.

Governance

The Ministry of Justice announced a change to administrative guidance effective as of 16 March 2015 to abolish the requirement that a GK must have at least one resident managing member (or a manager (*Shokumu Shikkosha*) as described below). While the residency requirement for managing members has been abolished, for practical and operational reasons it may still be necessary to have a managing member who resides in Japan. If the managing member is a legal entity, an individual—called a manager (shokumu shikkosha)—must be appointed to manage the corporate affairs of the GK on behalf of that legal entity. In principle, each managing member can represent the GK. However, a representative member may be appointed from among the managing members. Regular general meetings of members are not required.

The charter documents and other documents are filed with the Legal Affairs Bureau. A GK's company name, business purposes, the amount of capital, the names and addresses of representatives of its member (if the representative is a legal entity), the name and address of the managing member and its method of public notice are disclosed in the GK's company register and are publicly available.

Liability of the member of a GK to creditors is limited to the amount of equity participation.

Tax

The GK is popular with US parent companies because while the GK is taxed in Japan as a non-pass-through corporation on its income, a GK can be a disregarded entity (referred to as "check the box") for US tax purposes. The GK's income is subject to local and national corporate tax at the effective tax rate of 35.64 per cent. A distribution of dividends by the GK is subject to withholding tax at the rate of 20.42 per cent subject to exemption or reduced tax rates under applicable tax treaties. The GK does not enjoy preferential tax treatment on real estate investments as does the TMK or GK-TK (discussed below) and distributions from a GK to its parent company may be subject to withholding taxes.

4. GK-TK

Overview

This structure is (i) a GK property holding company together with (ii) an operating agreement, which together constitute a *tokumei kumiai* (TK). A TK is a form of (silent) partnership based on agreement between the TK investors and the GK as the TK operator. Under a GK-TK structure, a GK is established as a special purpose company whose purpose is to hold assets (such as fee property interests, trust beneficial interests (TBI), etc). Once an investor is identified, the investor enters into a TK agreement with the GK as the TK operator. The GK acts in a similar way to a general partner in a limited partnership under US law.

Pursuant to the TK agreement, the investor provides funds to the GK in exchange for the GK's obligation to distribute a share of the profits arising from the GK's business. The investor's role is limited to that of a passive investor with contractual rights under the TK agreement. The TK investor's liability is, accordingly, limited and the investors are not liable for obligations arising from the GK's business exceeding the amount of their respective contributions.

Incorporation

The incorporation process for a GK is straightforward as discussed at 3. above. Once the GK is formed, the TK investors will enter into the TK agreement with the GK. The TK agreement may be signed any time after the GK is formed and the GK and investor wish. The TK agreement is not filed or made publicly available.

Governance

The same simplified governance rules for ordinary GKs also apply to a GK-TK. In addition, since a GK-TK is supposed to be for passive investment by the silent partners this means that the operator—the GK itself—is the only party that is permitted to be active in the management and operations of the GK business.

In order for a GK (acting as a TK operator) to solicit investments and manage invested capital (which are treated as securities under the FIEA), the GK must either be licensed under the FIEA or fall within a permitted exemption. One exception to this requirement is if the TK investors include at least one QII and less than 50 non-QIIs, in which case only a simple notice filing of self-offering is required. To avoid this permit or filing obligation, a GK can outsource such investment solicitation and management to a licensed third party (for example, a licensed securities broker). There is a separate real estate permit required under the Real Estate Specified Joint Enterprise Act for a GK-TK to solicit, invest in direct real property interests and distribute profits therefrom, unless certain requirements for an exemption are met. If an investment is through TBIs (rather than directly in real estate) an exemption is available.

Tax

Similar to a TMK structure, when a GK makes distributions to investors pursuant to the TK agreement such distributions can be treated as deductions (as defined by the NTA's published regulations) against the GK's income. To qualify for this treatment, the TK agreement should specify that the investors' role is limited to passive investment. In practice, it is common for the management of the GK operator to be outsourced or handled by an affiliate of the investors. While the distributions of profits (dividends) may be treated as deductions against corporate income such distributions are still subject to withholding tax at 20.42 per cent, subject to reductions available under applicable double tax treaties. In summary, the GK-TK offers benefits very similar to a TMK in that:

(i) distributions to investors may be deducted against corporate income, limiting corporate tax liability to a very small amount; and

(ii) Withholding tax can be reduced if the investor is offshore by locating the investor in a jurisdiction with beneficial double tax treaty benefits.

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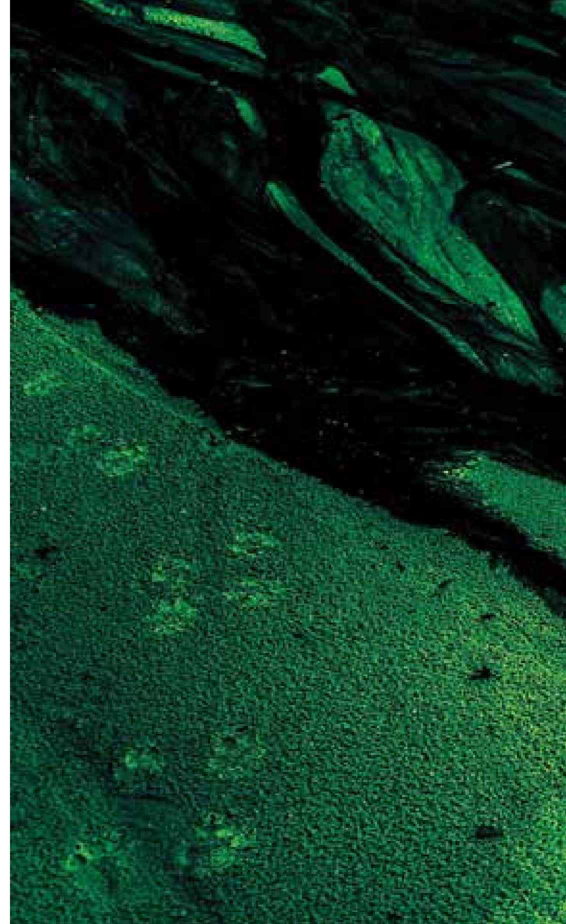


LIABILITY OF PROPERTY OWNERS FOR SOIL CONTAMINATION

AGATA KOCZOROWSKA, WARSAW

The issue of soil contamination can constitute a significant problem in a real estate transaction, in particular where the asset is in an industrial area. Further, determining the legal consequences of such contamination and the entity responsible for its removal, is a real challenge.

The issue is made more complex by the lack of consistent regulations in the Polish legal system governing this area, since, depending on the date on which the soil contamination was caused, the Polish Environmental Act dated 27 April 2011 (the 2011 Act) or the Polish Act on the Prevention and Remediation of Environmental Damage dated 13 April 2007 (the 2007 Act) applies, each introducing different regimes regarding liability for contamination.

Therefore, it is essential, in particular from the point of view of the buyer of real property, to determine, before the completion of the transaction, which regime applies, what are the possible risks connected with it and how to mitigate such risks.

Liability for soil contamination caused after 30 April 2007

For soil contamination caused after 30 April 2007 or resulting from activity which ceased after this date the regime created by the 2007 Act applies. This Act was passed in order to comply with Directive 2004/35/EC of the European Parliament and of the Council of 21 April 2004 on environmental liability with regard to the prevention and remediation of environmental damage.

Pursuant to the principle of "polluter pays" introduced by the 2007 Act, it is the entity which caused the soil contamination (irrespective of who is the current owner or occupier of the real property) which is obliged to undertake preventive or remediation measures. If more than one entity is responsible for the contamination, they are jointly and severally liable for remedying the environmental damage. Accordingly, if the contamination is caused with the consent or knowledge of the owner or occupier of the real property, both entities are jointly and severally liable for taking appropriate measures.

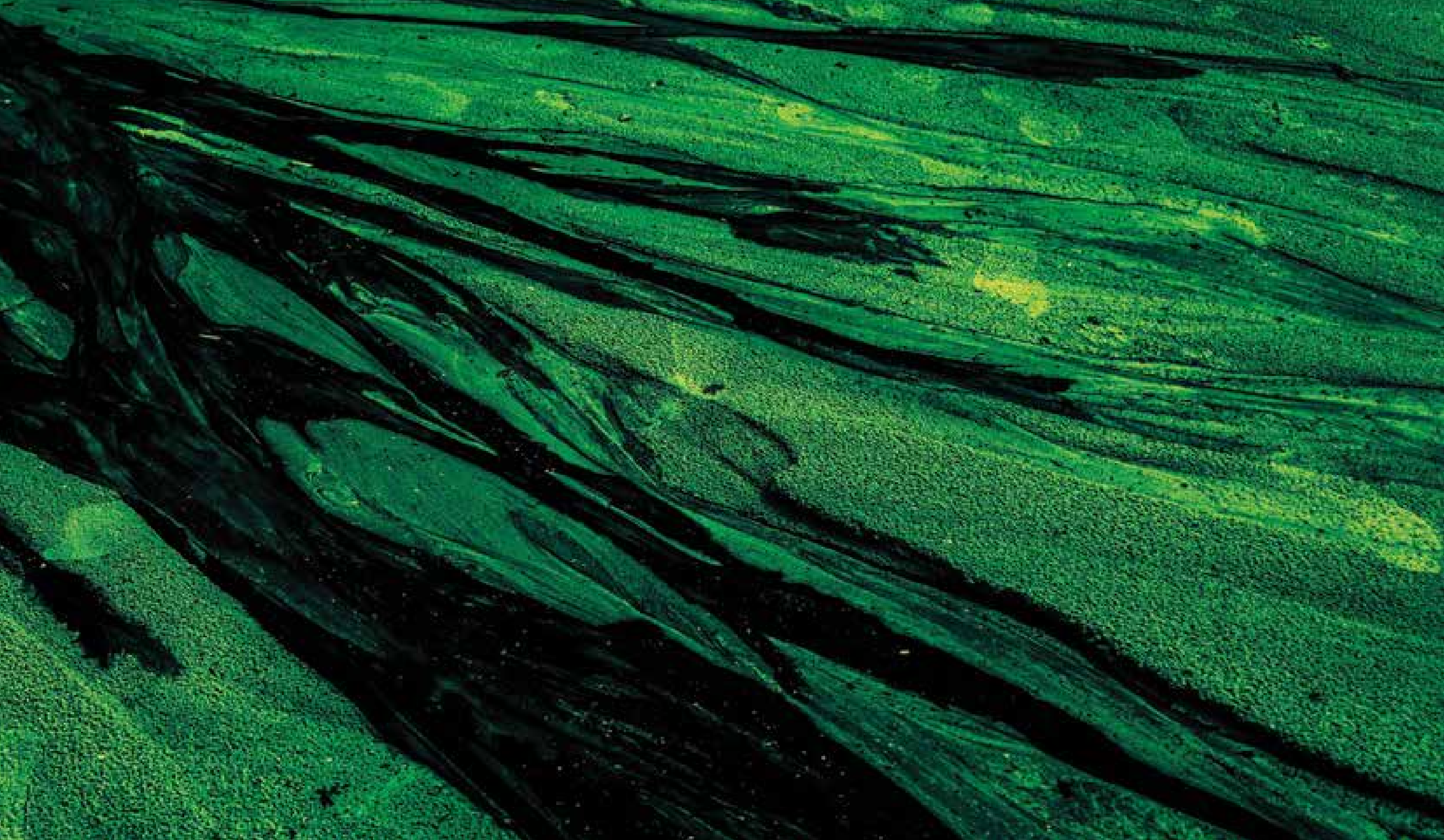
Within the scope of remediation the polluter is responsible for taking proper actions in order to remove or limit the substances posing a risk, controlling them and limiting their spread so that the contaminated area no longer threatens people's health and the environment, taking into account the current and, if possible, any projected uses of the area. Remediation may also take the form of the soil self-cleansing.

The remediation scheme is to be agreed with the environmental protection authority issuing a decision. Where the polluter fails to undertake remediation measures, the relevant authority will impose such an obligation on it. If the polluter does not have legal title to the real property, the owner is obliged to enable the polluter to conduct remediation activities but has the right to claim compensation for damage caused as a result of such activities.

Liability for soil contamination caused before 30 April 2007

For soil contamination caused before 30 April 2007 or resulting from activity which ceased before this date the regime created by the 2011 Act applies. The regime of the 2011 Act was amended recently (as of 5 September 2014) in order to implement Directive 2010/75/EU of the European Parliament and of the Council of 24 November 2010 on industrial emissions (integrated pollution prevention and control).

Under the 2011 Act, liability for what is known as "historical soil contamination" (ie pre-2007 contamination) is connected with the legal title to the real property and is expressed by the principle that "the owner or occupier of the real property pays". Before this recent amendment, the owner or occupier was obliged to carry out soil reclamation in order to remove the contamination, consisting of an obligation to reinstate the soil to the condition corresponding



to the quality standards set out in the Ministry of the Environment's regulations.

The obligation to carry out soil reclamation, which in many cases required significant efforts and costs, has now been replaced by an obligation to undertake remediation measures as defined in the 2007 Act and in accordance with a remediation scheme agreed with the protection authority.

In general, as indicated above, the entity obliged to carry out remediation in the case of historical soil contamination is the owner or occupier of the real property. However, if the owner or occupier proves that the contamination was caused by another identifiable entity, that entity is obliged to remediate. If the contamination was caused by another entity but with the owner's or occupier's consent or knowledge, the owner or occupier is jointly and severally liable with the polluter for remediating. The entity obliged to carry out the remediation may escape this obligation by proving that the contamination was caused before 1 September 1980.

Potential risks for the transaction

The obligation to remediate environmental damage may be both costly and time-consuming, in particular considering the fact that the scope of necessary works is determined by the protection authority in the decision by which it approves the remediation scheme. It is possible that the scope of remediation will be determined so broadly that it will in effect be reclamation. Therefore, it is essential to protect the interests of the potential buyer of the real property properly before the completion of the transaction.

The problem does arise with soil contamination caused after 30 April 2007 or resulting from activity which ceased after this date, where the principle "the polluter pays" applies, but for environmental damage caused before 30 April 2007 or resulting from the activity which ceased before this date where the principle of "the owner or occupier of the real property pays" the situation is more complicated. In such cases, there is a risk that the buyer will be held responsible for conducting remediation at its own expense, in particular, if it is impossible to identify the actual polluter.

In view of this, certain steps need to be taken in order to mitigate the risk referred to above and secure the buyer's position. Before the completion of the transaction the buyer should examine the condition of the real property. In particular, industrial and post-industrial areas are exposed to the risk of being classified as areas of historical soil contamination. In addition, the Director General of Environmental Protection maintains the register of historical soil contamination, encompassing those areas where such contamination has been confirmed and the areas potentially exposed to that risk. The seller should also commission a professional report on the degree of soil contamination, which should be delivered before the completion of the transaction.

If the analysis of the condition of the real property indicates historical soil contamination, the buyer's interests should be protected in the transactional documentation in one of two ways. The parties to the preliminary sale agreement may stipulate as a condition precedent to the sale that the seller is to carry out any remediation necessary to put the real property into a condition which complies with the applicable legal provisions. On the other hand, the parties may adjust the sale price to take account of the remediation costs, and the buyer will carry out the remediation but is compensated for the cost.

In either case the sale agreement should include an indemnity clause, by which the seller undertakes to reimburse the buyer if it incurs any future costs in connection with removing the historical soil contamination. However it should be noted that such a contractual agreement will not change the statutory rules on liability, but will only enable the buyer to seek compensation from the seller for losses incurred in connection with removing the contamination.

US CONGRESS COULD ACT TO ENCOURAGE FOREIGN INVESTMENT IN US REAL ESTATE AND INFRASTRUCTURE

BRUCE THOMPSON, WASHINGTON DC

United States tax law requires that all persons, whether foreign or domestic, must pay income tax on dispositions of interests in US real estate (US real property interests). Domestic persons are subject to this tax as part of their regular income tax.

Foreign persons and entities are taxed only on certain items of income, which do not include most capital gains. The US Internal Revenue Code treats the gain on a disposition of an interest in US real property effectively as income subject to regular federal income tax. To ensure tax collection from foreign taxpayers, the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) requires buyers of US real property interests to withhold 10 per cent of the sales price. The seller may apply to the Internal Revenue Service (IRS) to reduce this 10 per cent to the amount of tax estimated to be due. FIRPTA applies in virtually all cases where a foreign owner of a US real property interest disposes of that interest.

In contrast, other types of foreign investment, such as corporate stock, are not subject to US tax on the gain made.

As a result, FIRPTA discriminates against foreign investment in real property, and clearly has had a chilling effect on foreign investment in US real estate and infrastructure.

Special rules already apply where a foreigner hold interests in US real property through real estate investment trusts, or REITs. If the REIT is domestically controlled, meaning less than 50 per cent

> The proposal to use international tax reform as a source of funding transportation infrastructure investment has attracted bipartisan support in both Houses.

of the shares are held by foreigners overall, then a foreigner can sell his shares in the REIT without being subject to tax under FIRPTA, even if the REIT's assets consist entirely of US real estate. However, the REIT must generally withhold 35 per cent of cash distributions to foreigners to the extent those distributions are attributable to sales of US real property, but no withholding is required on distributions to foreign shareholders in publicly traded REITs who own no more than 5 per cent of the REIT shares.

A Senate report has been released which could give an impetus to the enactment of reforms to FIRPTA reforms. The Senate Finance Committee has released reports from its bipartisan working groups on tax reform, including a report from the International Tax Reform Working Group, co-chaired by Senators Rob Portman (a Republican Senator from the state of Ohio) and Charles Schumer (a Democrat Senator from the state of New York).

The bipartisan report recommends an international tax reform plan and a deemed repatriation proposal which would include revenue for a long-term extension of the highway trust fund, a federal fund devoted to road construction, finance for mass transit and remediation of leaking underground storage tanks. The proposal to use international tax reform as a source of funding transportation infrastructure investment has attracted bipartisan support in both the House of Representatives and the Senate,

> "President Obama supports exempting foreign pension funds from FIRPTA, and has included this proposal in his plan to encourage increased investment in America's infrastructure."

and could result in the enactment of tax legislation this year. Paul Ryan, Chairman of the House Ways and Means Committee, which makes recommendations to the House on all bills for raising revenue, welcomed the Senate report, and said he would act on the international tax reform legislation later this year.

The Senate working group report also included recommendations in support of FIRPTA reforms. According to the report, the working group believes that FIRPTA discourages foreign capital from flowing into much needed infrastructure investments in the US. The co-chairs thus agreed that two specific FIRPTA reforms "should be included in any international tax reform package."

These two reforms would:

- increase the ownership stake an individual foreign investor can take in a US publicly traded REIT without triggering FIRPTA liability from 5 per cent to 10 per cent; and
- exempt foreign pension funds from the restrictions imposed by FIRPTA.

Congressional tax writers in any event will be giving serious consideration in the second half of the year to an international tax reform package which would fund a long-term extension of the highway trust fund. The FIRPTA reform provisions could be included.

President Obama supports exempting foreign pension funds from FIRPTA, and has included this proposal in his plan to encourage increased investment in America's infrastructure. The President has said that "foreign investors including large foreign pension funds regularly cite FIRPTA as an impediment to their investment in US infrastructure and real estate assets. With US pension funds generally exempt from US tax upon the disposition of US real property investments, the Administration proposes to put foreign pension funds on an approximately equal footing".

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