



Buying a hotel in London?

London continues to be perceived as a safe haven for investment in real estate and demand for hotel assets among international investors remains strong. Many investors are new to the market and have little or no experience of investing in hotels and/or the London real estate market.

This briefing is intended as an overview of the legal issues to consider when buying a hotel in London. It is not exhaustive and does not deal with the general areas that must be addressed in any real estate transaction.

What are you buying?

It is important to know exactly what you are buying. In the case of a hotel, this might be the real estate asset, the property-owning vehicle and/ or the operating business (which may or may not be separate from the property-owning vehicle).

At an early stage of negotiations, consider what protections (e.g. warranties, indemnities, reliance on legal reports or other confirmations) are being offered. How extensive or limited these are will guide the extent and nature of your legal review and other due diligence needed.

Are you buying the hotel as an owner/ operator or as an investment, with the hotel business being operated on your behalf by a third party operator? If the latter, are you buying into an existing operating arrangement? It is most common for the major international brands to operate hotels under hotel management agreements, but you may also come across a lease or franchise agreement.

What's included in the sale?

Will the existing operator remain in place?

Consider whether the hotel is being offered with "vacant possession; you may pay a higher price for a hotel which is unencumbered by an operator; you may want to acquire the hotel without the existing operator in place with a view to operating the hotel business yourself or putting in place your chosen operator; perhaps, the hotel needs major refurbishment or redevelopment. Alternatively, you may be attributing value to the existing operation and brand and want to be certain that your acquisition will not affect this.

Your investment strategy for the hotel should be clear at the outset so as to guide your legal review. Depending on your strategy, you may want to consider:

- whether the existing operating contracts can be terminated and if so, when and at what price?
- the detailed terms of the existing contracts and in particular, the rights and obligations of the parties, the owner's controls, the various fees payable to the operator?

whether you are acquiring the hotel as a going concern (to continue trading without interruption). If so, check you are acquiring the real estate asset and everything in it including all furniture, fittings and equipment ("FF&E"), operating supplies (e.g. food and beverages) and small operating equipment (e.g. cutlery, crockery, linen, etc.), employees, intellectual property rights and the guest database. Understanding what assets are included is vital for the purposes of the valuation.

Legal contracts for hotel operation

- **Hotel operating leases:** Owner leases the hotel to an operator who occupies the hotel and operates the hotel business. Typically, business risk sits with the operator/ tenant, who pays rent to the owner/ landlord based on a share of revenue or profit generated by the hotel.
- **Management agreements:** Owner appoints an agent or contractor to operate the hotel business on its behalf. Business risk remains with the owner. The operator has no proprietary interest in the building. The operator receives various fees based on revenue and profits
- **Franchise arrangements:** Owner (or its operating company) is authorised to operate the hotel business under the franchised brand. Business risk remains with the owner/ operator. The brand owner provides relevant know-how and use of the brand name in consideration for payment of a fee, again based on revenue and profits.

- **FF&E ownership:** Ideally, there will be an up-to-date hotel asset register that records all FF&E that is to pass with the sale. However, this is rarely the case and you may need to rely on your own investigations and seek clarity in the sale and purchase contract as to what is included.

Watch out for FF&E that may be loaned or held under lease arrangements or hire purchase e.g. televisions, gym equipment.

- **Branded items and naming rights:** If operating arrangements are to be terminated upon acquisition, look for provisions in the operating agreements dealing with branded items. For example:
 - The operator may have an option to buy these items at "fair value" (likely to be nominal given they are branded).
 - The operator may require the items to be destroyed and the seller may seek to recover the resulting cost from you. You will want to resist this!

Consider the definition of "stock" to ensure that value is not attributed to branded items subject to such provisions.

Also, rights to the hotel name, any hotel websites, email addresses etc pass to you, as buyer, to the extent that the seller owns such rights in relation to the hotel only. Alternatively, they may be held by the seller for your benefit for a period of time to allow existing customers and service providers to be transferred across to the new brand.

- **Operating lease:** If an operating lease is in place, carefully check the terms of the operating lease to ascertain, among other things:
 - the extent to which the FF&E and operating equipment is owned by the owner and leased to the operator;
 - the scope of the operator/tenant's repairing obligations;
 - the requirements relating to the state and condition of the building when it is handed back to the property owner on the expiry of the lease; and
 - whether the operator/tenant's employees transfer to the owner on the expiry of the lease?

- **Are any parts of the hotel underlet?:** Your legal review should also ascertain whether any parts of the hotel have been underlet (e.g. restaurant or health club) and, if so, on what terms. Consider the impact on hotel turnover, the rent payable by the undertenant and to what extent the FF&E etc belongs to such undertenant. If your plans involve refurbishment or new operator arrangements, does the existence of an underlease create any obstacle?

Restrictions on the sale

Under operating leases and other management arrangements, it is common for the operator to have a right of first refusal/offer when the owner intends to sell. You should be sure that such arrangements have been identified and resolved before proceeding with the detailed legal review and negotiation of your purchase.

It is also common to see restrictions placed on the owner as to the identity of a buyer. At a minimum, these will prohibit sale of the hotel to any competitor of the operator. Again, these need early identification and resolution.

If debt is being used to finance your acquisition, most operators will require that the new hotel owner and its lender enters into a non-disturbance agreement under which the operator's rights under the operating agreement are protected should the lender exercise its power of sale. It is important to identify any such requirement early on and to commence negotiations early to avoid delaying the transaction.

Due Diligence

The above matters are important to identify early in the due diligence process. However, full due diligence of the underlying asset and business must also be carried out.

The following are some of the particular hotel-specific areas which will need to be covered:

- **Brand standards:** Those of international brands are co-ordinated and updated at an international level. Management agreements typically allow for an operator to implement such changes, which may in turn dictate the level of capital expenditure required and upgrading necessary by the owner. This can significantly affect cash flow and forecasts of operating expenditure.
- **Branding and IP:** The operator will own the intellectual property rights to the brand name, although these should be licensed to the owner to use in conjunction with the hotel for so long as the operating arrangements are in place. However, the hotel owner may own the intellectual property rights to the hotel's name, domain name or names of particular restaurants or bars in the hotel and if so all rights and title to these will need to be transferred to a buyer. It will also be important to ascertain who owns the rights to the guest databases and again, to the extent that ownership sits with the seller, ensure that these are transferred to the buyer. Check also compliance with all data protection policies. You should also verify that any IP rights are adequately protected.
- **Full survey:** This is particularly important to ascertain any capital expenditure requirements to bring the hotel up to brand standard or, where vacant possession is delivered, to understand the cost of any necessary refurbishment.
- **Licensing:** Ensure that all necessary and appropriate licences have been and will remain in place. For example, for the sale of alcohol, public entertainment, televisions and gaming.
- **Compliance with planning requirements:** In particular, consider accessibility for disabled staff and guests; the observance of all fire regulations and health and safety requirements including food safety and waste disposal.
- **Loyalty programs:** The international branded operators commonly operate these on a global basis. Ensure that you have understood how these will affect the hotel, for example by way of discounted accommodation rights. Potential adjustments between the buyer and seller should be considered, with an allocation of outstanding expenses between them. At a minimum, enquiries should be made to gauge the extent of the possible costs to the owner: these are unlikely to be clear from the hotel accounts and records.
- **Hotel accounts and records:** A detailed analysis and understanding of the business financials will be required, in particular to ensure a clear understanding of turnover and future capital expenditure requirements.
- **Employees:** Your acquisition may involve acquiring all employees of the hotel business, which will require a detailed understanding of the terms of their employment and all employee liabilities, in particular pensions. It will also be important to ensure necessary work permits are in place and that adequate measures

for PAYE administration have been and will be implemented.

- **Insurance:** You will need to be confident that all property and business related insurances are in place and if not, what will need to be put in place with effect from signing or closing.
- **Litigation:** There may be significant liability arising from ongoing disputes arising from the operating business or perhaps, damage to property.

- **Mixed-use scheme:** Many hotels are part of a larger development which may include commercial and residential elements. Ensure that you have disclosure of any rights for adjoining land owners to make use of hotel facilities and on what terms and the hotels requirement to contribute towards the cost of shared services and facilities used in common with other tenants.

Buying a hotel and its operating business requires specialist legal knowledge of the asset and the operating business as well as an understanding of the industry. Our Hotel specialists have this, bringing together industry knowledge, technical expertise and a commercial approach. Please get in touch if we may be able to help you with your hotel acquisition.

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