

Market Slowdown: Time for Hotel Acquisitions?

Lada Shelkovernikova
l.shelkovernikova@tamimi.com

March 2016

From a potential buyer's perspective, any slowdown of the market in general, and for the hospitality market in particular, presents a positive opportunity.

By way of example, the last 18 months have seen a particularly active time in Dubai for hotel acquisitions. The hotel industry particularly within the Emirate has matured, stabilised and become internationally established. For any investor considering a hotel purchase, this article sets out the recommended steps to be taken (and risks to avoid) from a legal perspective.

Legal Due Diligence

Should an investor underestimate the importance of legal due diligence, focussing only on financial analysis, the repercussions may be grave.

The scope of the legal due diligence is important, in order to reveal not only existing and potential legal risks, but also any risks related to:

- seller's title to the Hotel and underlying land, history of previous ownership and transfers, existing encumbrances and third party rights (including mortgages), compliance with master developer rules and regulations (including full payment of purchase price and community services charges), permitted zoning/use and any other restrictions or information that may impact the intended development of the land;
- the selling (and any holding) company's corporate and trading history, history of previous share transfers, shareholders, existing encumbrances over shares and confirmation on the company's current good standing, existing or threatened litigation or disputes;
- history of labour relations with hotel staff including compliance with labour contracts during employment and dismissal of Hotel employees, and compliance with employment laws, including trade union requirements if applicable,
- history of contractual relations with the hotel operator (if any), other third parties, and lenders (including the status of loan repayments under an existing mortgage, if any), to verify the status of any outstanding payments and other types of contractual breach that may lead to liability, and
- history of compliance of the hotel's operation with local laws, including licensing requirements, environmental laws, health and safety, sanitary requirements etc.

It is important to ensure that the investor is clear on his potential exposure due to any risks, (and in this respect, the effect of any statute of limitations under local law on historical issues), the extent of which will depend on the structure of the deal (either share transfer or asset transfer).

Where any risks are revealed in the course of legal due diligence, the investor, together with the seller, if possible, should assess whether such risks can be mitigated or eliminated by the seller prior to closure of the transaction. If the latter is possible, such actions should constitute conditions precedent to closing. Alternatively, the investor should consider the seller providing an indemnity (and the seller's financial strength should the indemnity be called upon), against any claims, damage, loss, cost or expense that may

be incurred by the investor in the future, if same relates to the period of time preceding closure of the transaction. In certain cases, however, the revealed risks may be incurable and so significant that they would need to be reflected in the acquisition price, or may prevent the transaction from proceeding.

Analysis of the Hotel Management Agreement

As part of the legal due diligence it is highly important for an investor to assess the hotel owner's rights and obligations pursuant to the hotel management agreement ("HMA") under which the Hotel is managed by an operator ("Operator"), since in the vast majority of cases the investor is obliged to assume all the current owner's rights and obligations under the HMA as an incoming hotel owner. Therefore, the investor should analyse whether the HMA provides for at least basic protections to the owner, for example annual budget approval rights; supervision of expenditure of funds and obligations to provide additional working capital; monthly and annual reporting by the Operator; owner's control/approval rights over capital expenditure and spending of funds from the FF&E Reserve; and the possibility to trigger the performance test or terminate the HMA without cause.

In case the HMA does not provide for such protections, the investor should thoroughly consider whether the transaction should be consummated, since in most cases, the existence of the HMA will prevent the investor from acquiring the hotel with vacant possession and, thus, should either take the Hotel with all obligations and commitments of the owner to the Operator, or leave the deal if he is unable to get comfortable with these.

Obtaining the Operator's approval

The procedure for a hotel sale is heavily regulated in most HMAs. As such, the Operator usually has a right of first refusal with respect to any sale of the hotel, which right should be strictly respected by the seller and the investor, to prevent any breach of the HMA and the threat of litigation or arbitration in the future. Unless there are no restrictions regarding sale of the hotel in the HMA, then usually, the seller should disclose to the Operator the investor's offer and the identity of the investor before any binding sale and purchase agreement is signed between the parties.

Under most HMAs, the Operator usually has a particular timeframe to either exercise its right of first refusal or alternatively approve the investor and assignment of the HMA thereto. In this respect, it is important to analyse whether the HMA provides for a clear approval procedure and criteria allowing the Operator to reject and prevent a sale. If there is no such mechanism, the buyer should assume the associated risks since if the Operator is entitled to reject the investor for no objective reason predetermined in the HMA, the investor's time and money invested into all preparatory arrangements up to that point (including broker's, appraisal, legal, consultancy and accountant's fees for legal and financial due diligence etc) may be wasted.

Termination of HMA on sale

If the HMA provides for the possibility for the seller to terminate the HMA on sale by paying the Operator an amount of liquidated damages, the investor should carefully consider whether or not it wishes to require such vacant possession and if it does, which party will ultimately pay the liquidated damages amount (or in which proportion will it be shared by the investor and the seller). The investor may wish to terminate the HMA and obtain vacant possession for several reasons – for hotel performance issues, or due to a requirement for a strategic change in the hotel's positioning (e.g. change of segment from midscale to upscale or vice versa, if feasibility studies have demonstrated that a different brand or operator may be preferable than in existence), or where the investor has a strategic relationship with another operator.

The investor should, however, keep in mind that payment of liquidated damages to the Operator would not be the only price for termination of the HMA, since all OS&E and FF&E, which associate the hotel with such brand and/Operator, will have to be removed from the hotel, together with a change of branding, and potential refurbishment/renovation of the Hotel to comply with the new operator's brand standards.

If the investor decides to require vacant possession, payment of liquidated damages and termination of the HMA should be a condition precedent to closing the hotel acquisition to ensure that the Operator will not have any claims against the investor in respect of the period of time preceding the closing of the transaction.

Transaction structuring

There are various options for structuring the acquisition of a hotel, the most common of which are:

- asset deal, i.e. by way of acquisition of the hotel building and underlying land by way of a real estate purchase;
- share deal, i.e. by way of acquisition of the shares of the company (or parent company), which owns (or otherwise has occupational rights to) the hotel and the underlying land;
- a combination of the above, i.e. incorporation of a newly established company (special purpose vehicle), to which the seller transfers the hotel building and land, and then sells the shares in such newly established company to the investor.

Each option of structuring has its own advantages and disadvantages, and must be considered on a case by case basis. In case of a share acquisition, the investor is exposed to the risks related to the selling company's corporate history and previous trading activity (including previous credit history etc) and liabilities. However at the same time, a share acquisition may be more efficient, since all personnel, permits and licenses necessary for the hotel operation, contractual arrangements with suppliers, etc are already in place in the target company's name and no additional actions or formalities are generally required by the investor (unless there is a change of control provision in any contract, which entitles the other party to terminate the agreement with the seller).

Vice versa, if the Hotel is sold by way of an asset acquisition, the investor is, on the one hand protected in terms of historical risks and liabilities of the seller's business activity and trading history, but on the other hand, all personnel, licenses and permits, and third party contracts will need to be assigned or re-executed in the name of the investor.

Considering the pros and cons of each option, based on the information obtained through the legal due diligence process, the investor's legal advisors should advise whether it is preferable to proceed with a share or asset transaction or a combination of both through incorporation of a new company to accommodate the transaction, and which particular conditions precedent/subsequent, if any, should be provided for in the sales documentation to ensure the maximum protection of the investor.

Acquisition of a distressed asset

Where the investor is considering the purchase of a distressed asset, which involves liability and outstanding payments owed to the Operator, then the investor should undertake legal and financial due diligence with respect to the existence of any breach of the following owner's obligations under the HMA:

- provision of additional working capital upon the Operator's request (where the revenue generated by the Hotel is insufficient to cover the operating and /or non-operating expenses of the Hotel);
- payment of Operator's fees and other charges due to the Operator under the HMA and ancillary hotel agreements;
- payment of FF&E reserve contributions;
- non-interference with the management of the Hotel by the Operator;
- undertaking capital works to the hotel as required pursuant to the annual budget or upon the Operator's request (as may be stipulated in the HMA);
- payment of property insurance premiums etc.

In order to reveal all owner defaults under the HMA, the investor should engage the Operator and, additionally, a mediator specialized in hospitality industry and hotel operation matters, in order to agree

on an action plan for settlement of existing claims by the Operator, and remedy of owner's defaults.

Such an action plan, once developed and approved by the investor and the Operator, should be signed between the two simultaneously with signing the sale and purchase agreement with respect to the Hotel. Otherwise, if such homework is not undertaken by the investor prior to the Hotel acquisition, the investor will be exposed to the risk of the Operator's historic claims against the previous owner and possible termination of the HMA in addition. This is due to the fact that assignment of the HMA requires that the investor assumes all rights and obligations and liability of the Hotel owner under the HMA. Furthermore, the HMA will usually provide that a party's failure to complain of any breach or default committed by the other party, irrespective of how long such failure continues, does not constitute a waiver of the non-defaulting party to seek remedies available to it under the HMA and applicable law. This means that the Operator would be entitled to pursue claims against the investor (as the new owner) with respect to events of default that occurred prior to its acquisition of the Hotel. In this respect, any limitation period should be taken into account, the length of which will depend upon the law chosen by the parties to govern the HMA.

In view of the above exposure, it is highly important for an investor to be aware of all historical events of default and potential claims against the existing owner, and to settle the issues with the Operator, with the assistance of a hospitality mediator if appropriate, prior to signing the sale and purchase agreement with the seller.