

Hotel Business Sale Agreements – Our Top Ten Insights

In brief

Thinking of buying or selling a Hotel asset? Here are a few thoughts.

Our experience in the buying or selling of hotels, whether it be in Australia or overseas, is that the same issues will come up again and again when making decisions about the sale process and subsequently drafting and negotiating your transaction documents.

[Introduction]

The sale or purchase of a single hotel asset or an entire portfolio is a complex, costly and potentially lengthy process, regardless of scale. But it is possible to introduce significant efficiencies which save time and greatly reduce the complexity and cost required to complete a transaction. For example, we recently acted for the vendor of the Sydney Hilton. This transaction presented us with the challenge of great complexity, multiple counter-parties including the purchaser and Hilton and the overwhelming necessity after many months of negotiation to bring the entire transaction to a satisfactory conclusion. The hotel sold for an Australian record single-asset price.

There is no one element of that or any of our other successful transactions which we can point to as being solely responsible for such a result, but rather a combination of process design, considered drafting of the transaction documents and commerciality on the part of the vendor and the successful purchaser. The ability to run a hotel transaction in this way whether for a vendor or purchaser has not come overnight – it is the result of more than 30 years of specialist experience in the industry.

[In depth]

1. Structuring | Asset or Shares?

Key to the design of many transactions is the desire of both parties to neutralise adverse tax or cash flow consequences, whether those consequences arise due to stamp duty, capital gains tax or GST, VAT or other value added tax implications. These costs are in most cases the first consideration of a vendor in deciding how an asset will be offered for sale, and a purchaser in choosing how to proceed with the acquisition.

In the Australian context, one of the more common hotel ownership structures involves a split between ownership of the underlying hotel asset and ownership of the business. This is something which may need to be retained in an acquisition (i.e.,, a purchaser will need to have two separate entities acquire each of these owners) in order to avoid the application of GST at a rate of 10% to the purchase price, whether or not the purchaser has a need or desire to retain differentiated ownership.

Structuring a purchase as a share sale will provide greater flexibility in this regard and in theory should exempt the consideration paid from most tax implications other than stamp duty or other transfer fees payable on the share acquisition. Dealings with contracts and ongoing commercial arrangements at the hotel are also much simpler in these circumstances as the contracting entity or entities remain the same before and after settlement. However, both vendors and purchasers need to consider the following implications of share sales when evaluating the various transaction structures available in particular circumstances:



- a. **Vendor concerns.** A vendor may have to incur significant additional costs in transferring the assets into new entities to facilitate a sale. Alternatively, many special purpose vehicles with widely held shares or units, have rules regarding sale or reallocation of those interests which are prohibitively expensive or administratively difficult to comply with.
- b. **Purchaser concerns.** A purchaser's primary concern should be connected with the fact that in becoming the owner of a company or trust and as such it inherits all past liabilities of those entities, on and from the date of settlement. This leads to an additional requirement for a purchaser to satisfy itself not just in regard to the hotel assets, but also in relation to the owning entities and any historical activities or outstanding liabilities of those entities.

In this context we also mention that any foreign purchasers looking to acquire a hotel in Australia will face recently increased fees should an application to the Foreign Investment Review Board be required. These fees increase by AUD 26,400 for every AUD 50 million of consideration. Fees start at AUD 13,200 for acquisitions of AUD 50 million or less, rising to a maximum of AUD 1,045,000 for acquisitions of more than AUD 2 billion.

TRADING TRUST CONCERNS – STRUCTURE CAREFULLY!

Hotels are accepted as a specialist class of property investment with their appropriate place in real estate investment trusts (**REITs**) and more general property portfolios. REITs and other trust structures are often favoured for commercial property, as a landlord receives rent 'passively' and can remain structured as a non-trading trust with its profits not being taxed until they are distributed to unit-holders. However, a hotel owner with a management agreement in place is deemed to be 'trading' and will be taxed as a corporation, potentially for the entire financial year in which that ownership occurs.

These serious tax implications may, depending on the particular asset and circumstances, be able to be addressed through the use of:

- Subsidiary companies who own the hotel business and hold the management agreement with the Hotel manager, and simply provide rental income to the owner through a lease arrangement
- Utilising a man-lease, a hybrid lease which provides greater certainty of income and the normal lease characteristics, but which has been tailored to include some of the hotel-specific management agreement terms

And it is important to consider these options and their impacts on requirements for the timing of exchange, settlement and hotel management documentation associated with a hotel sale or purchase.

2. Vacant or Managed | What's in a Name?

A hotel sold with vacant possession will usually attract a higher price than a hotel subject to an existing management contract. In most circumstances it is necessary to consider the terms and implications of a hotel management agreement before conducting a hotel sale process. Among the more common of these implications are:

- a. **Right to approve sale.** Most management agreements will include a right for the manager to assess and approve incoming purchasers. This usually specifies a number of requirements that the purchaser needs to comply with. Most importantly the purchaser cannot be a competitor of the manager.
- b. **Financier requirements.** Most operators will require the new hotel owner and any financier to enter into a 'non-disturbance agreement' with it under which the management agreement rights are protected in the event of the mortgagee exercising its power of sale. These documents can be particularly contentious and time consuming to negotiate, and the requirement to enter into such an arrangement should be identified as early as possible in the process. The management agreement may contain other restrictions upon the purchaser with respect to its financier (e.g., which financiers funds can be borrowed from, loan to value and interest exposure restrictions and obligations to provide the manager with copies of financing documents).
- c. **Construction Milestones.** If the hotel is still under construction then requirements may be imposed on the owner to achieve certain construction milestones by a specified date (e.g., construction commencement and completion,



financing). If these milestones are not achieved then this may allow the manager to terminate and sue the owner for substantial damages. Also if economic circumstances change such that hotel construction is no longer viable then the owner will not be entitled to change the use of the land to some other activity (e.g., commercial or residential development) without the manager's consent.

In Australia, a savvy purchaser should also determine whether an acquisition attracts GST. Generally this will not be the case as such an acquisition can be classified as an acquisition of a 'going concern'. However there are instances where such an exemption may not be available such as an acquisition of less than 100% of the hotel land.

GST IS NOT JUST A CASH FLOW ISSUE

If GST is payable on the acquisition of hotel land and business it is not a going concern (e.g., a purchase of less than 100% of the hotel land and business), that this is limited in its implications to an impact on short-term cash flow – i.e., it is paid at settlement and then recovered through the input-tax credit recovery system under Australia's GST laws. However, it needs to be remembered that stamp duty, which is payable on the transfer of land and assets at varying rates in all Australian States, is payable on GST *inclusive* consideration and is not recoverable from the government.

By way of example, in a AUD 100 million purchase of a hotel business and land, assuming a stamp duty rate of 5%, the GST inclusive consideration would be AUD 110 million and stamp duty payable would be AUD 5.5 million, AUD 500,000 more in unrecoverable expenditure than if the property had been able to be purchased for AUD 100 million as a going concern.

3. Due Diligence | Scope and Planning

Ultimately it is the extent, adequacy and availability of due diligence information which can determine the success or otherwise of a hotel transaction. Responsibility for initially preparing and offering this information to market rests with the vendor. This requires detailed planning, interrogation of key hotel personnel and collation of materials relevant to the hotel in an organised and easily digestible form.

GO ONLINE! THE PAPERLESS DATA ROOM

- The online data room has become an almost essential aspect of any successful disposal of an international hotel asset. They provide a central location with 24 hour a day availability for all communications, requests for information, draft transaction documents and all relevant due diligence materials to be maintained.

A well designed data room will be coupled with rules regulating access to and dealings with materials of various levels of sensitivity. Matters as simple and detailed as the form and manner in which questions or requests for information (RFIs) can be asked by purchasers and their consultants and the timing that can be expected for responses to those questions, can greatly contribute to streamlining due diligence processes.

4. Warranties | None, Some or Kit & Kaboodle?

Warranties and the negotiations surrounding them can be a significant sticking point in a hotel transaction. The starting point depends largely on the commercial aspects of the transaction, the desirability of the asset and the timing within which a deal needs to be done. Without any of these constraints however, a vendor's ideal position is to give no warranties at all and a purchaser's to have both the opportunity for full due diligence and then everything even marginally relevant to the asset subject to a warranty.

It is interesting to note then, that despite numerous lawyers in our team having over 30 years' experience in the field, we can count the number of times in which significant warranty claims or litigation have arisen out of a contract of sale, on the fingers of one hand. Ideally this is simply a reflection of the fact that we and our clients have done our jobs well, however while we hope there is a significant grain of truth to that, it is also realistically a reflection of the practicalities of warranty claims. No matter how extensive warranties may be, a breach of warranty claim is not only dependent on the original vendor still being around with sufficient assets to pay, but without vendor cooperation it will almost always require expensive court action to enforce, and therefore be justified in only the most material of circumstances.



CAPS, COLLARS AND RETENTIONS

With so much time spent arguing the substance of warranties, it is often easy to overlook the mechanisms behind them. A breach of a warranty by a party allows the other party to make a claim – failure to pay in accordance with that claim is then a breach of contract for which the injured party can take legal action. Such action is expensive and unlikely to be taken unless the matter is material.

However more importantly, the party standing behind the warranty needs to have sufficient resources to pay a claim, throughout the period within which claims are likely to be made. This issue becomes particularly important where a vendor for example, is a special purpose company that sells a hotel, distributes the proceeds to its unitholders and is then wound up. Purchasers need to ensure that this process is either delayed or that they have recourse to alternate proceeds to satisfy warranty claims in these situations, which could potentially be achieved by:

- The vendor being required to retain an agreed portion of the sale price for a period of say 12 months following settlement, in order to satisfy any claims (or alternatively the purchaser could withhold a portion of the sale price for that period)
- A vendor parent company guarantee or provision of bank guarantees to be called on in the event of a warranty claim

Positions on warranty caps, or total potential liabilities also differ, not surprisingly, between vendors and purchasers. A purchaser's starting position will usually be the purchase price, the vendor's as low as possible.

5. Hotel Services | Access Rights and Other Issues

When dealing with hotels or indeed any type of real property, both vendors and purchasers commonly assume that the visible access paths to the property, whether by way of stairs, roads or pedestrian walkways, are either all within the ownership of the hotel or else are covered by appropriate legal rights to allow such use. This assumption will rarely be based on a detailed analysis of the properties – unless a vendor has conducted a survey of the property or reviewed its access arrangements in preparation for sale, it is unlikely that any real examination of these rights has occurred since the vendor originally acquired the hotel.

Many hotels are affected by agreements relating to the sharing of electricity, water and other services (particularly in mixed use developments), and providing for access to the hotel over Council-owned or third party land. In most circumstances, these agreements were entered into on construction of the hotel and may have been subsequently overlooked or forgotten. From a purchaser's perspective, unless these agreements are specifically disclosed, it is often only by conducting a survey of the property (assuming time and cost allow for it) that issues relating to access can be identified and raised with the vendor.

There are a great variety of issues that we have come across relevant to this area, and we have set out below some of the more particular instances by way of example:

- The land onto which the fire exits of the hotel exit, is owned by a third party (and therefore at risk of being removed or developed in a way which restricts this access in future).
- Occupants of an adjoining residential development originally built at the same time as the hotel, have rights to access and use the hotel gym and pool facilities (creating operational issues and requirements for access to be maintained).
- A hotel held by way of a lease, remains surrounded by unleased land owned by the landlord, over which no formal rights of access to the hotel exist (as a result a purchaser would need to secure such rights or otherwise rely on an implied or common law right of access).
- The main driveway of the hotel is constructed over Council land and subject to an agreement under which the hotel owner must maintain that Council land and assume liability for any public injuries or damage to property that occur as a result of a failure to maintain.
- The hotel shares access to a carpark, part of which it utilises for its guests, with neighboring developments. As a result the hotel is required to contribute towards outgoings with respect to electricity, cleaning and capital repairs of the carpark as a whole.



The key with any of these scenarios is that appropriate preparation by a vendor or due diligence by a purchaser, will be able to identify these issues at an early stage and avoid them arising during some of the more crucial commercial negotiations on the transaction documents. Where approvals are required for assignment of existing access agreements, the timing for securing these approvals needs to be built into the overall timeline for the transaction.

Despite all of the above it is important to recognize that in some cases a solution to a particular issue may not actually be available, but these issues are precisely the ones which a vendor should identify and prepare for in advance so that they can be explained to a purchaser and a commercial decision to accept the relevant risk (or otherwise) can be made.

6. Employees | A Minefield of Options

As one of the greatest expenses associated with Hotel operations, properly contracting for appropriate assignment of employee responsibilities and adjustment of employee expenses, is crucial. Care is also required to ensure that the relevant transmission of business rules will properly apply to protect an incoming purchaser and outgoing vendor, from employee claims for termination (and resulting redundancy payment obligations) that might otherwise arise on sale. This generally means that discussions in hotel transactions with respect to employees centre around two key areas, being adjustment of employee benefits and liabilities, and the purchaser's obligations with regard to offering employment to transferring employees.

There are a number of different categories of adjustment with respect to employees, some of which are always adjusted, some of which are rarely adjusted, and others which vary on a transactional basis. Of course one way to avoid employee adjustments altogether on a sale is for the vendor to terminate all employees and pay out all remaining liabilities, with the purchaser then employing those employees afresh from settlement. Such a course of action would rarely be followed however as a number of additional costs and liabilities may arise, depending on the particular employment contracts and industrial instruments that apply.

One further aspect of these employee adjustments, at least in the Australian jurisdiction, is a cash-flow one. Since the payment of employee entitlements is a tax deductible expense for a business, most vendors will only propose adjusting 70% of the monetary value of these amounts, effectively claiming its tax deduction 'up front' from the purchaser. A purchaser will in future, be required to pay out 100% of those amounts but can then claim the 30% tax deduction, and not end up out of pocket.

THE EMPLOYEE CLAUSE – KEY AREAS

We have set out below some of the key employee issues which in our experience, need to be considered in any sale or purchase of a hotel business. These are based on the assumption that in most circumstances a hotel business owner will act as the employer for all hotel employees. In the rare situation in which this role is performed by the hotel manager, the process on sale will be simpler.

- **The process.** Employee meeting, provision of a required form of employment offer to the purchaser, timings for offers to be made and accepted.
- **Standard of offer.** The terms on which a purchaser will be required to offer employment to transferring employees.
- **Employees post-exchange.** Role of purchaser in approving new employees before settlement, ongoing obligations of vendor.
- **Adjustments.** Method of calculation, scope and timing.
- **Incentives and Bonus Schemes.** Quantify outstanding amounts, post-settlement adjustments and obligations of purchaser to assume schemes.
- **Industrial instruments.** Disclosure of all relevant instruments for the particular employees and purchaser awareness and compliance with all relevant provisions.
- **Superannuation.** Allocation of liabilities prior to and after settlement, purchaser membership of relevant industry super funds.
- **Redundancies.** Liability for redundancy claims and other employee disputes arising out of sale process.
- **Disputes.** Attempted resolution at vendor/purchaser level, referral of disputes to independent third party.



- **Post-settlement access.** Necessity for vendor to obtain access to employee records, requirement for ongoing cooperation with purchaser.

7. Post-Exchange | Passing of Risk, Hotel Operations

There will usually be a period following exchange during which various preconditions under the contract are satisfied, adjustments are calculated and the purchaser otherwise prepares for acquisition of the hotel.

In most circumstances, the vendor retains all the risk of the Hotel but the parties may agree that certain matters, for example the issue of a statutory notice requiring significant capital works, may need to be jointly complied with by the vendor and purchaser. A purchaser's main concern during this period is that the hotel continues to run in accordance with standard practices and that the standard of the hotel business and assets remains at completion, subject only to fair wear and tear, the same as at the date of exchange of contracts. In other areas a purchaser will, quite rightly, seek to maintain a level of control over the granting of new contracts, carrying out of capital expenditure works on the hotel, hiring of new employees and other material business decisions made after exchange, which it may be required to inherit or adjust for on settlement.

APPROVALS AND PRECONDITIONS

A number of the issues raised above give rise to a requirement for approvals, novation deeds or other assignment documentation to be completed in order for a purchaser to complete its acquisition and be able to properly operate the hotel following settlement. It is during this post-exchange period that these approvals are sought and documented.

The requirement for these approvals needs to be identified during the due diligence process and addressed in the transaction documentation. To the extent they are vital to hotel operations, purchasers would usually seek to make their satisfaction a precondition of settlement occurring.

Consideration needs to be given to the party that will control the process of seeking and finalising these approvals and the consequences of failing to use all reasonable endeavours to do so.

8. Adjustments | Timing, Arrears Collections and Books

In a similar vein to employee adjustments, adjustments at the broader hotel level (and we are talking here about hotel business adjustments, not the more straight-forward asset adjustments relating to land tax, rates and the like) can be complex and variable from one transaction to the next. The structure of the particular hotel business and the extent to which the hotel business owner takes an active role in supervising and calculating hotel expenses, will also affect the way in which these adjustments are carried out.

RETHINKING THE STOCKTAKE

The settlement stocktake is often one of the more costly and inconvenient aspects of a Hotel sale for vendors and purchasers alike, both practically and in the negotiation of clauses governing stocktake procedures and disputes. Despite this, parties often assume that it is a necessary and incidental inconvenience of the sale process. In reality, there is almost always sufficient information available to both parties to reach agreement on a genuine pre-estimate of stock value. This then becomes a very simple pre-agreed figure for adjustment to be inserted into the sale agreement.

9. Disputes | Think Ahead

It often surprises us the number of parties that either assume a sale process will flow smoothly once contracts have been exchanged, or at the other extreme, assume the worst and that in the case of any dispute, they will simply proceed to court. The reality is, there will almost always be matters under a contract that the vendor and purchaser have some form of disagreement about, and there should be an appropriate mechanism in the contract documentation to deal with that situation.

In our experience, these clauses and the process of parties negotiating and agreeing on their content, itself provides a strong disincentive from disagreements escalating to the point that the clauses are actually activated. One of the most practical techniques in this regard is to build into a dispute resolution clause a requirement for the parties to refer any matter deemed to be an official



'dispute', to the CEO or General Manager of their respective organisations. This should be a required first step before the involvement of a third party expert or any ability to take the dispute to arbitration or into the Court processes. In practice any issues which do not have material financial impacts will be negotiated to a resolution rather than taking them to such a senior level.

Obviously there will be some matters, particularly in relation to adjustments, which require input of a technical nature and which may not otherwise be able to be agreed between the respective senior officers. To the extent an independent expert is then given the ability to determine that dispute, parties need to decide whether that decision will be final and binding or capable of appeal to the courts.

10. Consultants with experience and experience add value

We will not labour the point but it should be obvious that hotel transactions are complex. In our view, as you would expect, a smart party, whether a vendor or purchaser, should engage consultants with the requisite expertise and an established successful track record in negotiating and concluding similar transactions. This is not only the lawyers but all the consultants which are needed to make such transactions happen.



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