

## Foreign Hotel Managers & Branded Residence Licensors – The good news and the not so good news about the impact of Australia's Foreign Investment Regime

### In brief

Many, if not most hotels in Australia are managed by foreign hotel managers such as Accor, InterContinental Hotels Group, Marriott, Hilton, Hyatt, Shangri-La, Langham, Ace, and The Standard. Their remuneration generally includes fees calculated by reference to hotel revenue and hotel profit. Branded residences, whilst common place overseas, having their roots in New York city in the 1920s, are only beginning to emerge in Australia.

Residences overseas carry such well-known brands as Four Seasons, The Ritz Carlton, Yoo inspired by Starck, St Regis, Trump, Fairmont, Yoo Studio, Rosewood, W, Mandarin Oriental, Banyan Tree, Aman, Six Senses, Address, Pininfarina, Waldorf Astoria, Hilton, Westin, Kempinski and Raffles.

In Australia, all of the current crop of brand owners are foreign (even Crown following the company's A\$8.9 billion acquisition by global private equity behemoth Blackstone). The charge is being lead by the yet to be completed Mondrian (Accor's Ennismore) and 1 Hotels (SH Group) with at least two others in the pipeline.

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### In depth

We have discussed branded residences in detail previously [here](#). Brand owners license developers to sell residences under a specific brand the intellectual property rights to which are controlled by the brand owner.

Brand owners usually charge the developer a fee which is calculated as a percentage of the residence sales price. Licence fees typically range from 3.5%-6% of residence sale price for luxury hotel brands, 2.5%-5% for upper scale hotel brands and from 1%-4% for non hotel brands. Overseas evidence suggests that attaching a brand to a residence can increase the sale value by as much as 31% (**Source: *Branded Residences: An Overview by Graham Associates***).

The purpose of this newsletter is to inform the reader as to the impact of the Foreign Acquisitions and Takeovers Act 1975 (**FATA**) which is administered by the Foreign Investment Review Board (**FIRB**) on the business activities of foreign hotel managers and residence brand owners.

In short the impact generally for hotel managers is minimal. However the impact in the branded residence space can be significant and if the relevant laws are not complied with could have potentially disastrous consequences for a broad sweep of affected persons including the brand owner, the developer, the residence owners and their respective financiers and advisers.

#### The relevance of FATA

Australian law imposes restrictions on foreign persons acquiring an interest in Australian land. The most common examples are when a foreigner seeks to acquire a freehold or leasehold interest.

However, section 12(e) of the FATA sets out that an interest in an agreement involving **the sharing of profits or income from the use of, or dealings in, Australian land will constitute an interest in Australian land** if it is reasonably likely, at the time the interest is acquired, that the agreement will run for more than 5 years. Subject to the relevant monetary threshold being met, entry into such an agreement will then require FIRB approval. The purpose for this provision is to prevent a foreigner from side stepping the intent of the legislation by acquiring the economic benefit of Australian land even though a property transfer (e.g acquisition of land by freehold or leasehold means) has not taken place.



If the legislation applies or may apply then a foreigner is bound to seek approval from FIRB. If the acquisition is made without the relevant approval then FIRB may issue orders for the acquired interest to be disposed in addition to the potential imposition of imprisonment and hefty monetary penalties detailed below.

## The Impact of FATA

### a) Hotel management agreements

The fees charged by hotel managers technically may constitute an interest in Australian land because such fees are calculated by reference to revenue and profits of an Australian hotel which constitutes Australian land.

The counter argument is that a hotel management agreement is a service arrangement between the hotel manager and the hotel owner and even though the fees are charged by reference to hotel profits or revenue the aim of the arrangement is not to indirectly acquire an interest in Australian land.

This is a very grey area but fortunately there is a concession which generally disposes of the issue. For the purposes of FATA, hotels are normally considered to be commercial land and in such cases a threshold of \$330 million applies (or the higher \$1.427 billion threshold for investors from certain jurisdictions). In other words, if the acquisition is less than the threshold amount then approval is not required. The approach generally taken to determine whether the acquisition amount is less than the threshold is to undertake a calculation which approximates the net present value of the fee stream under the management agreement (including any extensions) and if the resulting amount is less than the threshold then an application is not required.

We are not aware of any situation where the fee stream under any relevant management agreement has exceeded the threshold.

### b) Branded residences agreements

It is a completely different situation for branded residences. As discussed in detail in our prior newsletter, branded residence arrangements involve multiple documents between the brand owner and the developer. The most relevant for present purposes is a document which is usually referred to as the Residential Sales And Marketing License Agreement (**RSMLA**). Under the RSMLA the brand owner licences the developer to use the brand in relation to a residences sales programme in return for a fee which is usually a percentage of the residence sales price.

As the licence fee is calculated as a percentage of the sales price of the residence which is Australian residential land, the FATA is relevant.

While the issue is sidestepped in relation to management agreements because of the threshold, the same situation does not apply in relation to branded residences because the threshold for residential land is nil – in other words, **there is no threshold**.

By parity of reasoning as applies to hotel management agreements, the counter argument is that an RSMLA is a service/licence arrangement between the developer and the brand owner and even though the fees are charged by reference to residence sale price, the aim of the arrangement is not to indirectly acquire an interest in Australian land. We note that, despite the fees being determined by reference to a percentage of the residence sale price, this does not necessarily alter the character of the fees as being payment for services. The fees are likely to be viewed as being contractual in nature, being related to the use of intellectual property, and as such, likely to be sufficiently removed from the use of / dealings in Australian land so as not to require approval.

Notwithstanding the availability of the counter-argument, in "Yes Minister" speak (apologies to younger readers if this reference doesn't resonate), it would be "a very courageous decision" by a legal adviser to opine that FATA absolutely does not apply to a foreign brand owner and run the risk that FIRB may take enforcement action against the foreign brand owner.

For completeness, in order for the entry into an agreement to require FIRB approval, the agreement has to be one which involves the sharing of profits or income from the use of, or dealings in Australian land. Since the precise meaning of this phrase has not been judicially considered, it is difficult to comment with any certainty on the requisite level of interdependence / proximity that will give rise to a finding that the profits or income arise from the use of or dealing in Australian land such that an agreement will rise to the level of an interest in Australian land. In our view, the prudent course in each instance is to prepare and lodge a formal FIRB application even though such applications are time consuming to prepare and consequently can be costly. However, such cost pales into insignificance in comparison to the application fee that may apply in these circumstances.

According to FIRB's guidance on fees, it expects applicants to have a reasonable estimate of future profits for the life of the agreement. Practically speaking it will be helpful to keep FIRB's guidance regarding calculating the consideration for leasehold interests in mind when assessing the fee for an RSMLA application because, in some respects, FIRB treats interests in Australian land acquired by lessees and licensees similarly. The formula for calculating the consideration of a leasehold interest is simply:



- Any upfront or initial payments required for the grant of the interest; plus
- The periodic payments for the benefit of the Australian land; plus
- Amounts likely to be paid for extension or renewal.

The minimum fee for acquiring an interest in residential land (other than an established dwelling – which we assume would generally not be the case in the present circumstances) is \$4,300 (for an interest that is valued at less than \$75,000). The filing fee generally increases by \$29,500 for every \$1,000,000 increase in the value of the interest being acquired until reaching the maximum fee of \$1,171,600 (for an interest that is valued at \$40,000,000 or more). So for example, if the brand owner's estimated all up payments and amounts taking into account the formula referred to above is \$15,000,000 then currently the fees would come to \$413,000. If however, the acquisition is deemed to be an interest in an established dwelling then the fee currently for a \$15,000,000 acquisition is \$1,239,000 and for \$40,000,000 or more is \$3,514,800. These are obviously very substantial sums.

Where a lease will extend beyond 20 years, the consideration should be adjusted (using reasonable assumptions where necessary) to the relevant payments (calculated in accordance with this formula) over the first 20 years.

The fees increase by a lesser increment up to \$2,000,000 acquisition price (i.e., the fee increases by \$4,300 for an acquisition that is for more than \$75,000 but less than \$1,000,000 and by \$10,400 for an acquisition that is for more than \$1,000,000 but less than \$2,000,000.

If a FIRB application is required and is not lodged then the foreigner is potentially liable to significant penalties and fines.

Failing to make an application in relation to a notifiable transaction in breach of FATA can attract the following maximum penalties in relation to residential land:

#### *Criminal*

- For an individual - years' imprisonment or a penalty of \$4,695,000 or both
- For a corporation - a whopping penalty of \$46,950,000;

#### *Civil*

The greater of:

- The capital gain that was made or would be made on disposal of the relevant residential land;
- 25% of the consideration; and
- 25% of the market value of the relevant residential land.

If the penalties are not enough to attract your attention, the Treasurer is also empowered to order that the relevant interest in Australian land be disposed of. In the case of freehold land it is relatively easy to understand what disposal entails - a transfer of the land from the foreigner to a party which does not have a legal impediment to so acquire. In the case of a leasehold interest the foreign person would need to transfer the lease to a person that did not have a legal impediment and if no such person can be identified then it would seem that the foreigner would be bound to repudiate the lease and suffer the consequences which would presumably be a substantial damages claim by the lessor.

In the context of an RSMLA, it would not be commercially possible for the foreigner's interest to be novated (transferred) to another person as this would also require the foreigner to transfer the intellectual property rights to the relevant brand. In our view the only course available to the foreigner would be to repudiate the RSMLA and suffer the consequences which would presumably be a substantial damages claim from the developer. If the agreement between the foreigner and the developer is repudiated then any rights to market the residences under the brand would potentially cease to apply and expose the developer to damages claims from the purchasers of the residences (particularly if at the time of repudiation the agreements for the sale of the residences have not completed) and potentially others including relevant financiers.

The further question arises, what is the fate of any associated licence agreement which allows the developer or the body corporate of the building which contains the residences to display the brand on the outside of the building and refer to the brand in correspondence and otherwise. This licence agreement may not in and of itself constitute an interest in Australian land but could FIRB make orders with respect to that agreement and other agreements inextricably connected to the RSMLA?

It will be self-evident that it is not only the foreign brand owner who needs to know whether the foreign investment laws have been adhered to but also the developer, the residence owners and their respective financiers and advisers.



We have firsthand experience in relation to the need for FIRB applications with respect to both foreign hotel managers and residence brand owners and would be pleased to explain in further detail the issues involved and, where necessary, assist with the preparation and lodgment of any relevant applications.

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