



## ABA Section of International Law 2017 EUROPE FORUM

Look out for falling bricks: How to develop your historic hotel in Europe

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## SECTION A COMMON FOREIGN INVESTMENT STRUCTURES

### 1 ACQUISITION ROUTES AND HOLDING STRUCTURES

1.1 Investors in commercial real estate (including hotels) in the United Kingdom typically invest indirectly via holding vehicles rather than owning the asset directly.

1.2 There are various benefits in acquiring and holding UK commercial real estate through a vehicle, including tax efficiency. Indirect investment can also facilitate the introduction of multiple investors into a structure, thereby spreading the risk and returns from the property between investors (and, if tax transparent structures are adopted, allowing them to structure their investments in an optimal way given their respective entrance points).

1.3 Popular vehicles for private indirect investment into UK property assets (including hotel bricks and mortar) include:

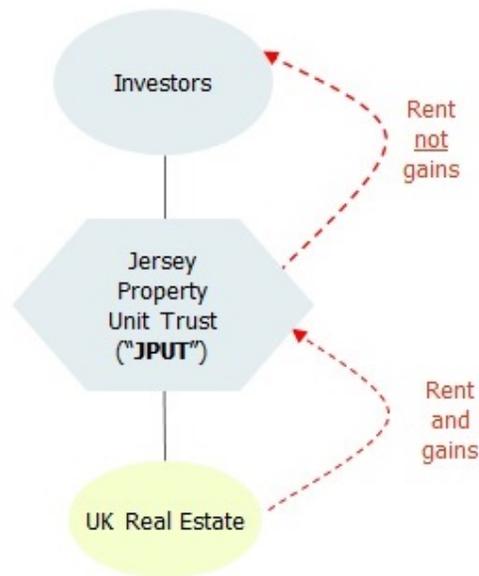
- [non-UK company](#);
- [property unit trust](#) (which is most commonly established and resident in the Channel Islands (Jersey Property Unit Trust ("JPUT") or Guernsey Property Unit Trust ("GPUT"));
- [English Limited Partnership \("ELP"\)](#);
- [English Limited Liability Partnership \("LLP"\)](#);
- A structure using both a JPUT/GPUT and an ELP (usually in the case of development properties).

Below is an explanation of the more commonly used of these vehicles:

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## 2 JPUT/GPUT



- 2.1 A Jersey Property Unit Trust (“JPUT”) and a Guernsey Property Unit Trust (“GPUT”) each involve appointing a professional trustee in Jersey or Guernsey respectively who will hold assets on trust for investors. These professional trustee firms are generally made up of lawyers and administrators in Jersey/Guernsey. (For ease, the below commentary just refers to JPUTs but GPUTs have very similar characteristics and involve similar considerations and benefits.)
- 2.2 A JPUT is a unit trust established in Jersey. A unit trust is formed on:
- the execution of a trust deed by one or more trustees; and
  - the transfer of property to the trustees, to be held in accordance with the terms of the trust.
- 2.3 Trustees hold the property on trust for the benefit of the ‘unitholders’.
- 2.4 JPUTs are governed by the trust deed and are not generally subject to extensive regulatory controls. Typically, a trust deed will set out:
- the extent of the trustee’s powers;
  - the appointment, removal and retirement of the trustee; and
  - the issue, redemption and valuation of units.
- 2.5 Over a decade ago we saw a proliferation of the use of JPUTs to hold UK property. This was largely due to the fact that - until 2006 - UK tax law allowed property to be transferred to a JPUT trustee without Stamp Duty Land Tax (“SDLT”) being incurred. This advantageous position, known as “seeding relief”, led to a number of high-value UK commercial properties being held in JPUTs, including some landmark hotels. Although “seeding relief” was abolished in 2006, JPUTs have remained popular vehicles given certain desirable features as described further below.
- 2.6 JPUTs are generally treated as transparent for UK income tax purposes. It is, therefore, the unitholders who pay UK income tax on the income from the property rather than the JPUT. When undertaking any due diligence on a JPUT structure, we will examine the trust deed to check that it

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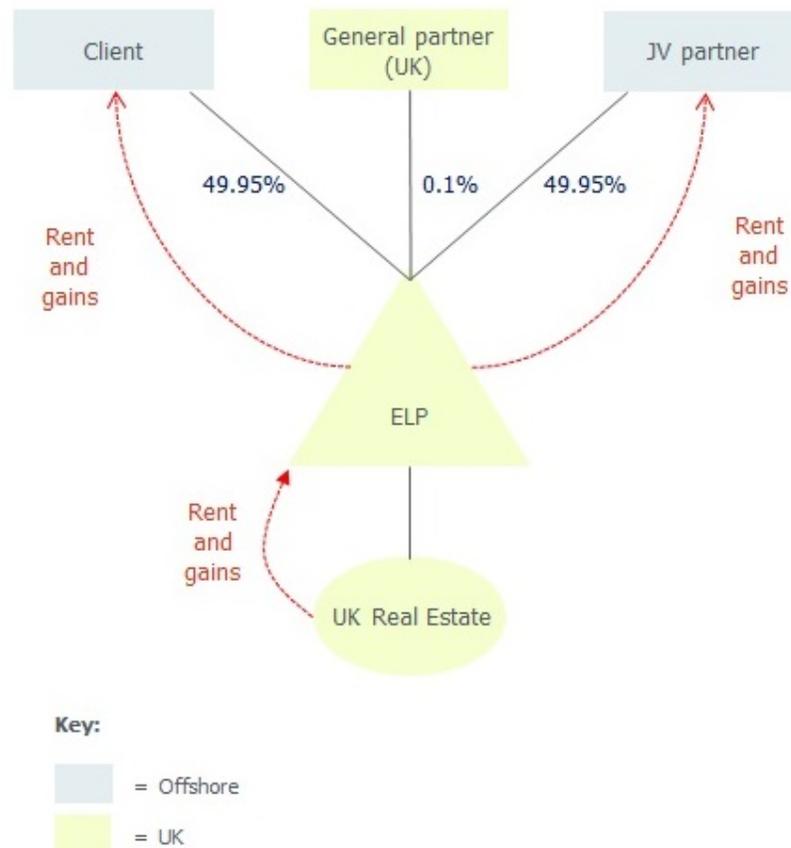
is a "Baker Trust" and therefore has the features we would expect, i.e. that it is transparent (mainly that any profits derived from the trust property are at all times trust income held by the trustees on behalf of the beneficiaries/investors).

- 2.7 There are generally no transfer taxes on transfers of units in a JPUT and so this is a popular level at which to trade interests in UK real estate. Other benefits include:
- Income transparency so rent is treated, for tax purposes, as arising directly to unitholders rather than being taxed at JPUT level. This has made JPUTs very attractive investment vehicles for tax exempt institutions.
  - Provided the JPUT is managed and controlled outside the UK, such that it is not UK tax resident, there is no UK tax on the disposal of UK property held as an investment.
- 2.8 Consent of the Jersey Financial Services Commission is needed to establish a JPUT. If there are more than 15 unitholders or 15 offers for units, additional regulatory consents are required (although in hotel development arrangements we deal with they are normally closely held unit trusts with only a few participants).
- 2.9 A JPUT needs to be a collective investment scheme under the Financial Services and Markets Act 2000 for certainty of tax treatment (this is key for tax transparency).
- 2.10 A JPUT may also be classified as an Alternative Investment Fund under the Alternative Investment Fund Managers Directive, in which case it must have an Alternative Investment Fund Manager appointed, and comply with the AIMFD rules and regulations applicable to it.
- 2.11 Further details can be found in BLP's Basic Guide to a JPUT.

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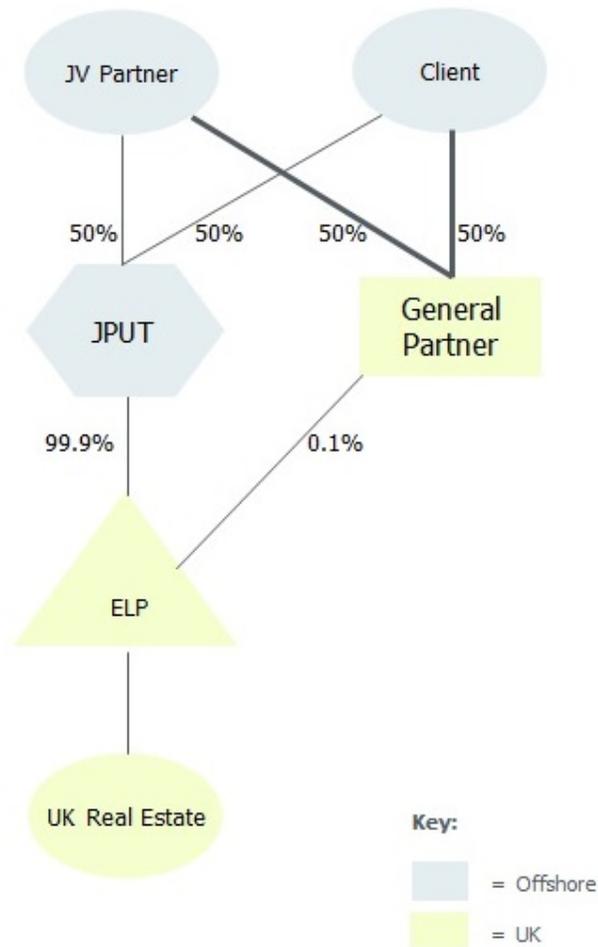
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## 3 ELP



- 3.1 An ELP is a partnership established under the Limited Partnerships Act 1907.
- 3.2 English Limited Partnerships have traditionally been popular vehicles for indirect real estate investment, because they are tax transparent for direct tax purposes, enabling different types of investor to invest together, but to be taxed according to their individual status.
- 3.3 ELPs offer limited liability to investors provided that they are not involved directly in management and so the investors participate as "limited partners". An ELP is managed by its "general partner" which has control over the management of the partnership and unlimited liability for the debts and obligations of the partnership. Meanwhile, the liability of the limited partners is limited to the extent of their investment provided they do not take an active part in management of the ELP's business. ELPs must have at least one general partner and one limited partner.
- 3.4 Conveying interests in an ELP attracts Stamp Duty Land Tax in the UK. For this reason, they are often used in conjunction with offshore vehicles to enable day-to-day management of investment property assets to take place onshore, without prejudicing the general tax status.
- 3.5 Refer to BLP's Basic Guide to an ELP for a more detailed overview of this investment vehicle.

## 4 JPUT/ELP COMBINATION



- 4.1 A JPUT and an ELP are often used in combination, particularly in a development context. This is because investors can invest in the JPUT, which holds the beneficial interest in the ELP. The ELP then invests in and manages the UK real estate.
- 4.2 This structure enables day-to-day management of real estate assets to take place onshore (in the UK) while preserving the tax benefits of using a JPUT, which must be managed and controlled offshore.
- 4.3 Generally, the JPUT part of the structure will:
- only hold an investment in the ELP as a long term investment and will hold no other assets;
  - be managed and controlled in Jersey by a resident corporate trustee to maintain non-UK tax residence;
  - be held as a long term investment by the unit holders (although the corporate unit holding vehicles will often be traded as will the JPUT units themselves).
- 4.4 Traditionally, JPUT/ELP combinations were useful vehicles in which to hold hotel and other UK real estate development projects. This is because the capital gain realised from the development of

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the hotel could be realised without the investor, upon exit at that level, having to pay UK capital gains tax through selling units in the JPUT. However, there have been some recent changes to the UK tax regime introducing more stringent anti-avoidance rules which make it more difficult to achieve a tax free exit (at either asset or share level), particularly where development of the land has been undertaken.

## 5 TO CONCLUDE ON INVESTMENT AND DEVELOPMENT STRUCTURES:

- 5.1 The above is not an exhaustive list. There are, for example, a number of onshore listed vehicles that might lend themselves to hotel investments. UK Real Estate Investment Trust or (“REITs”) are increasingly popular for commercial property investment because UK legislation has recently been amended to relax certain REIT requirements enabling joint venture REITs and what are, effectively, single-asset REITs. However, there are limitations in the context of hotel ownership, because a REIT is only tax exempt on rental income and so the trading income profile of hotel operations can cause them to fall foul of the conditions for remaining in the UK REIT regime. This means that structuring is required to separate property ownership (rental income) from hotel operations (trading income) – see Opco/Propco below.
- 5.2 Although tax is a significant factor which may influence the choice of vehicle or structure, other factors such as familiarity, regulatory issues, cost, location of management and practicality will also help determine the choice of vehicle.

## 6 BEST/USUAL LOCATION FOR AN INTERMEDIARY

US investors into the UK have commonly routed investments through Luxembourg to utilise the benefit of the double tax treaties and often the availability of hybrid instruments to maximise tax efficiency for funding investments. Luxembourg has long been a favoured jurisdiction for holding UK property because it does not tax capital gains arising from UK land, shares in a Luxembourg company can be acquired free of transfer taxes and Luxembourg offers a stable political and tax environment that is acceptable to a wide range of investors.

## 7 DOES A FOREIGN PARTNER NEED A LOCAL PARTNER/SUBSIDIARY?

It is not essential to have a local partner or subsidiary. There are no restrictions on foreign ownership or occupation or real estate in England.

## SECTION B OPCO/PROPCO

- 7.1 When holding a hotel in the UK (as in other European jurisdictions), it is common to have an “operating company” (“**Opco**”) separate from the property owning company (“**Propco**”).
- 7.2 Key drivers for this approach are the following:
- A better price/more marketable on exit: The Propco will generally be more attractive when you come to sell it because it is not tainted by potential operational liabilities (the Opco will generally procure contracts etc leaving them with the operating risk);
  - A better rate on financing of the Propco: Banks generally like to be able to take security over a separate propco because it means that they can enforce that security on the property without necessarily getting tangled up in any operational issues that might be there when the business is in trouble. This is a common reason for opco/propco structuring and I have been involved in a number of corporate restructurings into opco/propco purely for the reason that better finance terms can be obtained for an operational property-based business in this way.
  - Tax: a number of different tax advantages are possible:
    - (i) CGT: when you come to sell an asset, if it has been held offshore by a non-UK resident, there will be no UK tax on chargeable gains arising from the sale;
    - (ii) income tax: there were historic benefits in relation to the rate of corporation tax but UK rates are reducing and at 19% are currently lower than the 20% income tax rate applicable to non-residents so this will be less of a driver to have income accruing to an offshore vehicle (although watch this space as our elections are coming up and if Labour gets in (unlikely) they will raise corporation tax significantly which will drive corporations to invest through offshore vehicles).
    - (iii) Tax deductibles - Opco/propco leases can offer tax efficiency to the overall investment. Opco is able to deduct the cost of rent paid to Propco from trading income derived from operating the hotel. Propco can use interest deductions (assuming it is leveraged) and capital allowances to lower its effective rate of tax on the rental income from Opco and Propco can, provided it is tax resident outside the UK, preserve growth in value in the hotel property outside the UK tax regime.

## SECTION C ACQUISITION: ARE SHARE AND ASSET DEALS COMMONLY USED?

### 8 ASSET DEALS

Even though the corporate route is predominant, hotels are also traded at asset level which means having an asset and business transfer agreement. Higher taxes on the transfer of land in England is the key driver for the popularity of acquiring English real estate through acquiring shares in an English special purpose vehicle or at some other level. For high value real estate assets the SDLT rate is 5% and when you compare this with the 0.5% stamp duty on the transfer of shares in an English company, there is a significant difference in the overall transaction cost.

If selling interests in an offshore vehicle then, subject to certain conditions, there should be no UK stamp duty payable on that transfer.

Set out below are the key elements of an asset deal and a corporate deal in that order.

#### 8.1 Title and encumbrances - how is good title proved?

There are fundamentally different land law regimes in the different parts of the United Kingdom (England and Wales, Scotland, Northern Ireland, the Channel Islands and the Isle of Man). This paper only discusses the law relevant to properties situated in England and Wales.

Most land in England is registered at the Land Registry. The Land Registry maintains records on all registered property, including information such as the names of owners, the price paid for the property and a plan of the properties' boundaries. Most dispositions of land must be registered with the Land Registry, which will ask to see certain documentary evidence before processing the registration. This process is strictly managed because the Land Registry gives a state guarantee of the class of title with which the property is registered.

Broadly, there are four classes of title: absolute, possessory, qualified and good leasehold. An absolute title is the best class of title and the one that will be granted in the vast majority of cases. Exceptionally, however, where evidence is lacking or a defect in title is apparent, the Land Registry may instead grant one of the other classes.

Because the entries on the Register are conclusive evidence of ownership and are guaranteed by the state, if a defect or error is found in a registered title, compensation may be payable by the Land Registry in certain circumstances.

#### 8.2 Investigating title

When acquiring or developing a hotel or other real estate in England using third party financing, it is common for the purchaser's lender to insist that a "certificate of title"<sup>1</sup> is produced – usually by the seller's or developer's lawyers. This is a well-established means of any lender or purchaser of real estate to be assured as to the quality of the title to the real property concerned and any matters affecting it. While Certificates of Title are in a form which will address matters that affect the property as it is used at any given time, they are a "snapshot" of the matters impacting that property for its current use: They are not very well suited to development properties, however can, through careful drafting, be adapted to address the current use and the proposed use of the

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<sup>1</sup> This is a standard form produced by the City of London Law Society and it gives a number of confirmatory statements as to the quality of title, encumbrances and other matters that may impact the investment value of the real estate concerned.

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property once developed. They would not, however - in any significant development scenario - be sufficient to assess the property and the ability to carry out the proposed development. In the case of any complex development, a full legal development constraints report would be prepared to assess any title, planning and other legal/regulatory impediments.

## 8.3 Conveying title

Title to English property is transferred by registering the transfer with the Land Registry. Stamp Duty Land Tax must be paid before the transfer can be registered.

Upon becoming registered owner of real property, a purchaser will have certainty that it is the legal and beneficial owner of the property. This effectively means that only matters that "run with the land" can be conveyed to the buyer – proprietary interests and not contractual liabilities. This is the fundamental difference between an asset dealing and a share dealing in England. No "legal person" is being acquired with an asset deal and so it can't sue and be sued in the same way that a corporate body can.

What this means for a hotel acquisition at asset level is that any non-proprietary interests such as licences that are key to operating a hotel (for example, supply contracts, food and beverage licences, wedding licences and spa licences) must be specifically assigned over to the buyer because they don't otherwise transfer with the property.

## 9 SHARE DEAL (OR DEALING WITH OTHER INDIRECT INTERESTS SUCH AS JPUT UNITS)

### 9.1 Conveying real estate through shares or other indirect interests

With indirect dealings, where the shares or other interest in a holding vehicle are being conveyed, there will not be any change in the registered owner of the property.

As in the US and other jurisdictions, there may be change of control issues associated with the interest so there is always a review of contracts to check if a share sale might trigger a payment, termination or a right of the hotel operator to change the contract terms or, in the case of a hotel franchise, implementation of a "property improvement program" or "PIP".

Whereas a property transfer conveys only those things that "run with the land" or are specifically and contractually conveyed to the buyer, when buying a vehicle you are stepping into a legal entity that can itself contract and incur liability: a buyer will inherit any contractual arrangements entered into by that vehicle and its other liabilities. The question as to whether a company is clean or tainted by claims or other liabilities is therefore highly relevant and will be a matter for legal review by the buyer and disclosure by the seller.

While in a pure direct real estate dealing, the buyer places some reliance on warranties, these are generally limited to things like the capacity and authority of the seller. This is because with a real estate transfer, it is easier to understand the full extent of what is being conveyed by investigating the seller's title, matters affecting it and the state and condition of the property.

Given the position is not so clear when you buy a corporate vehicle, greater reliance is placed on matters disclosed by the seller and the warranties given by the seller that it has in fact disclosed all material issues and liabilities affecting the target entity.

You might also rely on an indemnity if there is a known contingent liability that could give rise to a claim against the target company in the future (a key example is tax liability but it could also be a potential claim in relation to other matters – e.g. environmental).

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Awareness of seller: In a hotel deal the seller will seek to limit their potential liabilities as far as possible and when acting for buyer, we always keep our ears and eyes open to identify any 'key man', i.e. who is the "brains of the business" /who would be aware of the issues that affect the business – and make sure their awareness is deemed to be part of the seller's awareness.

## 9.2 **W+I insurance**

The other possibility is warranty and indemnity insurance.

W&I insurance has become an increasingly common feature of corporate real estate transactions in the UK in recent years.

Known risks are typically excluded from the cover but it may be possible to obtain specific policies depending on the nature of the risk.

Subject to any specific exclusions, the policies generally give cover up to the limits of the insurance cover which our clients typically buy at between 10-20% of the purchase price.

The cover is sought where adequate covenant protection is not available from the seller. Reasons for this might be:

- the seller may be unwilling or unable to give financial cover for warranties – for example, because it wants to make an immediate distribution of the sale proceeds (and will therefore not want to have any part of the consideration held back for any period of time);
- the buyer might be concerned about the seller's covenant strength.

For corporate hotel deals in the UK, W&I premia tend to range between 1 – 1.5% of the insured value. This depends on exclusions and extent of cover and a specialist broker is always involved to look at insurance options and likely costs.

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## SECTION D LICENCES AND HERITAGE ISSUES

As in most European jurisdictions, hotel operations rely on a number of crucial operating licences such as food and beverage/liquor and in some cases gaming licenses as well as others.

In addition, a key feature of developing any historic hotel in London and other parts of the UK and Europe will be heritage consents. Below is an outline of some of the features of the regulatory regime for listed buildings.

The listing system is largely governed by the Planning (Listed Building and Conservation Areas) Act 1990 ("**LBA**"). Once designated as being 'on the list' a building (which can include part of buildings and also monuments and sculptures) is subject to protection under the LBA.

The different categories of listing are not an express part of the LBA, but are set out in the relevant Government guidance, and are used in associated national and local planning policy. Grade 1 is the highest level of listing designation, and intended to represent buildings of "exceptional interest".

Historic buildings are very attractive assets for hotel operation, but developing them into a successful hotel operation has challenges.

Section 7 of the LBA provides that "no person shall execute or cause to be executed any works for the demolition of a listed building, or for its alteration or extension in any manner which would affect its character as a building of special architectural or historic interest" without authorisation – which comes in the form of a listed building consent.

A listed building consent will normally be granted subject to conditions (including a time limit for commencement – usually 3 years).

Carrying out of works (including partial or complete demolition) without listed building consent is a breach of section 7 of the LBA and a criminal offence. So too is the carrying out of any works which do not comply with the conditions of the listed building consent.

If the Local Planning Authority or Historic England suspect unauthorised works, they can issue a Listed Building Enforcement Notice. There are no time limits for enforcing this kind of breach and so enforcement can be taken in relation to works carried out by previous owners (against a present owner).

Generally, with very significant heritage buildings, it is critical to engage with a local conservation officer and relevant Historic England advisor as they both need to be supportive of any proposals (which is always better achieved before any formal submissions are made).

A key feature of any significant heritage development is that the public have significant affection for these buildings and they often have iconic resonance with the wider identity of the city. Given this cultural and historical significance, they are always going to be subject to considerable scrutiny.

## **SECTION E REFURBISHMENT WORKS: ARE TURNKEY AGREEMENTS POSSIBLE?**

- 9.3 Yes, hotel developments can be procured by way of a turnkey construction agreement. However, given the challenges of developing historic buildings (including the uncertainties around the structural fabric of the building and M&E systems), these kinds of adaptive reuse projects may lend themselves more to an approach that will facilitate design development by the owner/developer (with input from an operator once selected). Because of the dynamic between owner/developer and operator, it may not be possible to identify at the commencement of the project some of the details to be delivered in the finished operational hotel.
- 9.4 Given that some of the design features of a hotel will not be clear when the construction works commence, it will generally be more expensive to engage a contractor on a turnkey basis (requiring subsequent variations to reflect a developing design) than having a progressive procurement approach.
- 9.5 Even if a developer starts out on a progressive procurement route, the legal documents should include the requisite level of detail in the specification to facilitate the ultimate contractor assuming responsibility for the entire delivery. In the case of historic buildings this may not be a realistic expectation if there are features of the building that the contractor does not properly understand (e.g. where the external features of the building have to be retained). In this situation, both English Heritage and the Local Authority will need to be involved and balancing the operator requirements and expectations with the physical constraints of an historic building may be complex.

## SECTION F HOTEL OPERATING STRUCTURES

The key legal contract structures for hotel operation are as follows:

### 9.6 Hotel operating leases:

With this approach, the owner of the hotel grants a lease to the operator who occupies the property and operates the hotel as an agent for the owner. Typically, the business risk sits with the operator who pays rent to the owner (its landlord) based on a share of revenue or profit generated by the hotel.

### 9.7 Hotel Management Agreements

Under a Hotel Management Agreement, the owner appoints an operator to operate the hotel business on the owner's behalf. The owner bears the risk and financial rewards (after fees paid to the operator) of the hotel operation. The operator is a contractor and has no proprietary interest in the hotel building. It generally received fees based on revenue and profits.

### 9.8 Franchise arrangements

A franchise arrangement is where the owner of the hotel property (or its operating company) is granted a licence to operate the hotel business under the brand name of the franchisor. In this arrangement, the business risk remains with the owner and the brand simply charges a royalty fee and gives access to its central/brand purchasing power to the owner/operator for a fee.

## SECTION G MIXED-USE HOTEL DEVELOPMENTS

### 9.9 Key drivers

The hotel mixed-use concept materialises in various forms. It might be that residential apartments are developed in combination with a traditional hotel which, at the luxury end, might involve “branded residences” as a means of creating further value from the adjoining hotel operation. Other more varied combinations might include a mix of residential, retail and office space and perhaps entertainment venues such as theatres and concert arenas. Serviced apartments have also been a prominent feature of the mix in the US and Asia and market predictions suggest we are increasingly likely to see this in the UK.

There are some real benefits to taking the mixed-use approach to hotel development but also some potential pitfalls to consider. Some of the key drivers for combining a new hotel development with other uses in a mixed-use environment include:

- a more challenging debt finance landscape;
- increased likelihood of obtaining a favourable planning permission: planning authorities are attracted to uses that generate employment;
- the desirability of creating a “living community” rather than a more sterile stand-alone hotel environment (depending on the nature of the hotel of course!).

In a more challenging debt market, developers are looking to make their hotel development appraisals work by incorporating elements that can be contracted for sale early in the development programme, with the proceeds being a funding source for the hotel's construction. There might also be elements that can be let for commercial, leisure or other uses for a more steady income stream to service debt following completion of the development. It's worth noting that from a lender's perspective, the lengthy gestation period of a typical new-build hotel development, from conceptual stage, through the planning and construction stages, right through to the end of a 3 year income stabilisation period (being the earliest point at which a realistic capital value can be established) may be regarded as unattractive, relative to other real estate asset classes.

### 9.10 Some legal issues with mixed-use developments with residential elements

Under English law, there are various statutory rights which residential tenants may enjoy as a result of occupying residential premises, including the right to collective enfranchisement, pre-emption on disposal, service charge recovery control and property management. This all depends on various factors but you should always consider the following where there is a residential component in your mixed-use scheme:

- Enfranchisement: right to buy the freehold: In the UK, in certain circumstances, tenants of long residential leases (over 21 years) have a collective right to purchase all superior interests up to and including the freehold interest of an apartment building. This is subject to thresholds and qualifications that should be investigated at the early stages in any mixed use development scheme.<sup>2</sup>
- Right of pre-emption: tenants of apartments with long leases in the UK and at low rents may have a collective right to “take over” any proposed disposal of the reversion by their landlord who must offer to make that disposal to qualifying tenants before offering it for

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<sup>2</sup> Leasehold Reform, Housing and Urban Development Act 1993

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sale more widely. This is a right that can be managed through careful structuring: it only exists against the immediate landlord and so an intermediate entity can be used to prevent the issue for ultimate investors who want to hold their investment without the pre-emption having an effect on their future dealings.<sup>3</sup>

- Service charge recovery: UK legislation stipulates that landlords of residential tenants are required to consult with and allow tenants to make observations on particular matters regarding service charge (subject to certain contracts/works qualifying for application of the relevant provision) but hotel/residential mix operators should assume that at least some elements of their service charge will be caught by these regulations.<sup>4</sup>
- Losing the right to manage: in certain circumstances in the UK, residential leaseholders are able to take over the management of their apartment block without needing to show default on the part of the landlord or its management company. While the right to manage might, in theory, seem in jeopardy, it is unlikely to be one any resident would want to exercise where a block is well maintained and well managed but one to be wary of in any case.<sup>5</sup>

## 9.11 Branded residences

In any jurisdictional context, there is always a real tension to manage between the immediate desire for the investor/developer to sell apartments with the kudos of the brand alongside the assurance sought by a buyer of an apartment that the brand and the standards will be there for the longer term. A couple of issues to navigate include:

Long term covenants: if the apartments enjoy services from the adjoining hotel (e.g. concierge or a menu of extras such as cleaning, florist, room service), is there a long term promise to be made by the hotel owner to keep operating as a hotel? If the hotel operation is to be closed for a time to be refurbished or if in some years it becomes a better investment option to change the use from hotel to offices, are there any restrictive covenants in favour of or promises to adjoining apartment owners that prevent realising another investment goal? Acting for investors, I am always keen to ensure clients are aware of constraints that could suppress the long term value of the real estate in changing circumstances – and limiting these where possible. It is always a balance between immediate value realisation and long term value appreciation.

Brand certainty and the cost of maintaining that: sophisticated buyers of residential apartments which are sold at a premium for the brand association will want to understand what this means for them in the longer term. How long is the name on the door and how much will it cost to keep it? What if they re-brand? Is this going to cost the apartment owner if they change the logo – say from a Starwood brand to a Marriott one? This consideration is perhaps heightened in a world of consolidation of hotel operating companies. Perhaps not an issue at the forefront of the mind of your general apartment buyer but one that will need to be managed no less.

## 9.12 The food and beverage (F&B) offering

F&B has become an important aspect in the future of driving revenue in hotel operations. Having a destination to eat not only for those staying in the hotel but for the street life outside the hotel and for the general public and the local market is key. Sophisticated hotel operators and investors are looking for the “foodie” experience as part of the mix in their hotel development. Many hotels

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<sup>3</sup> Landlord and Tenant Act 1987

<sup>4</sup> Landlord and Tenant Act 1985

<sup>5</sup> Commonhold and Leasehold Reform Act 2002

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now have a street entrance to their restaurant and either a well-known restaurant or a renowned chef as part of their F&B offering.

Historic hotels tend to be at the luxury end of the hotel investment market and so developing investors will often want to have a say in how the F&B is run and in the choice of the restaurant operator/anchor chef to ensure the offering is in keeping with the historic characteristics of the hotel.

### **Getting in touch**

Please don't hesitate to get in touch if you would like to discuss anything covered or raised within this report.

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## Development of historic hotels: outline of Italian Law elements

This paper has been prepared in the context of the 2017 ABA–SIL Europe Forum concerning the development of historic hotels in Europe, with a focus on Italian Law.

This paper is only a summary of certain topics and it is not aimed at providing a full and complete description.

### A. INVESTMENT STRUCTURES

#### (i) The “reciprocity principle”

A preliminary concern for foreign investors in Italy is the so-called “reciprocity principle”. More in detail, pursuant to a (seldom applied) provision of Italian law, non-Italian nationals are allowed to invest in Italy only if their country of origin allows equivalent rights to Italian investors, or if their country of origin has an international treaty with Italy which allows such investments. While this rule is not relevant for investors from the UE or from most non-UE countries, in some residual cases it is worth checking the issue in advance, and if necessary set up an investment structure through an UE country or a country which allows reciprocal investments by Italian investors. Except for such residual cases, there is no legal need for foreign investors to set up joint ventures with (or to invest through) an Italian operator when acquiring real estate assets.

#### (ii) Asset deal or share deal

The acquisition of Italian real estate assets may occur either *(a)* through an asset deal, where the investor acquires the real estate asset directly or through an Italian vehicle set up by the investor, or *(b)* a share deal, where the investor (or its Italian vehicle) acquires an interest in a company or an investment fund which holds the real estate asset.

Asset deals are usually simpler, as the purchaser does not acquire liabilities or contracts concerning the asset unless the share deal is structured as acquisition of a going concern (in which case contracts and liabilities of the going concern are usually transferred to the purchaser). This allows for a simplification of the legal due diligence (usually focussed on title to the asset and encumbrances on the same, tax regime applicable to the acquisition, compliance of the asset with applicable laws and lease agreements) and of the negotiation of the acquisition agreement.

On the other hand, if the acquisition regards not only the real estate asset but also the relevant going concern (as is often the case where the acquisition of historical hotels is concerned), due diligence and negotiation usually are more complex as all aspects of the going concern need to be taken into account.



On the other hand share deals entail certain additional legal complexities, such as legal pre-emption rights, formalities and a complex tax regime which depends inter alia on the kind of real estate asset being sold and on its characteristics.

Share deals entail that the purchaser acquires an interest in the whole entity which owns the asset.

This usually requires a broader due diligence, not only on the real estate asset but on the whole entity, its assets and liabilities and any contracts or other relationships of the same. For similar reasons, the relevant acquisition contracts and their negotiation are usually more complex than those concerning an asset deal.

On the other hand, the relevant acquisition formalities are generally simpler than those for the acquisition of real estate assets.

### **(iii) Acquisition vehicles**

Most (but not all) acquisitions of Italian real estate assets are carried out through an Italian investment vehicle, for multiple reasons, such as benefiting from a limitation of liability, obtaining “no recourse” financing, benefiting from an Italian investment manager, obtaining a specific tax regime.

Such investment vehicles can generally be separated in two main groups, i.e. (a) non regulated vehicles and (b) regulated vehicles.

#### *(a) Non regulated vehicles*

Non regulated vehicles are mostly corporate vehicles (joint stock companies or limited liability companies). Such vehicles can be set up specifically for the acquisition, or an interest in such vehicles can be acquired to acquire (indirectly) the real estate asset.

The main advantage of such vehicles compared with a direct acquisition of the real estate asset are the limitation of liability, the ease of setting up no recourse financing and the possibility of sharing (indirect) ownership of the real estate asset among multiple investors through the allocation of shares or other equity interests. Shares and equity interests can be structured to grant to their holders different rights and powers both in terms of distribution of dividends and of corporate powers concerning the management of the vehicle.

Real estate joint stock companies can also be listed on the Italian stock market, and if certain requirements are met (mostly concerning small shareholding and focussing on returns from leasing activity) can apply for a specific tax regime (so-called SIIQ – *società immobiliari quotate*) which offers significant tax benefits.

Investors in non regulated vehicles can (directly or through the board of directors and shareholders' meeting) take all decisions concerning the management and operations of the vehicle and, consequently, of the real estate asset owned by the vehicle.

Please note that, subject to compliance with the abovementioned reciprocity principle, foreign nationals can be appointed as directors of non regulated vehicles.

*(b) Regulated vehicles*

Regulated vehicles can be either corporate vehicles (SICAFs), or investment funds. Such regulated vehicles can be set up specifically for the acquisition, or an interest in such vehicles can be acquired to acquire (indirectly) the real estate asset.

Regulated vehicles offer the same benefits of the non-regulated vehicles in terms of limitation of liability, ease of setting up no recourse financing and possibility of sharing (indirect) ownership of the real estate asset among multiple investors, plus a beneficial tax regime and the benefit of management by a specialized asset manager.

The main drawbacks of such vehicles are:

- (a) the relevant costs (in terms of management fees and compliance costs), which limit the use of regulated vehicles to transactions above a certain size;
- (b) the significant level of surveillance by regulatory authorities and (in view of the significant tax benefits involved in using such vehicles) by the tax authorities; and
- (c) the limited scope of their activity.

The costs arise mostly from the need to have a regulated specialized and regulated asset manager which manages the vehicle. Such asset managers are remunerated through management fees usually based on a percentage of the assets under management. Most Italian regulated vehicles are managed by Italian asset managers, even though lately some investment funds have been set up and managed by asset managers based in other EU countries thanks to the so-called AIFMD management passport.

The regulatory and tax overview mentioned above is often focussed on the role of the investor in managing the vehicle and its investments. This is due to a general principle of Italian law pursuant to which the investors in this kind of regulated vehicles should be "passive" investors, and most decisions concerning the vehicle should be taken by the regulated management company. While the investors can usually have a certain level of involvement in the main investment decisions (e.g. through advisory committees or similar bodies), this is often a significant issue for investors.

The scope of activity of regulated real estate investment vehicles may prevent from carrying out certain other activities (e.g. entrepreneurial or commercial activities). While this limitation in scope can sometimes be addressed by incorporating a non regulated vehicle

(usually a limited liability company) which is owned by the regulated vehicle, also the activity of such controlled vehicles should have a real estate focus. As a consequence, where the investor's activity is not limited to the real estate investment, but includes for instance the operation of a hotel, it may be appropriate to hold the real estate asset through a regulated vehicle which then leases such assets to an operational (non regulated) vehicle which carries out the activity.

Please note that, subject to compliance with the abovementioned reciprocity principle, foreign nationals can be appointed as members of the advisory committees of regulated vehicles or even as board members of the relevant asset management companies.

## **B. REAL ESTATE RELATED ISSUES**

### **(i) Title and encumbrances**

Italian real estate assets and most in-rem rights over the same are registered in a specific real estate registry, which is connected to the real estate tax registry (the "cadaster").

The real estate registry allows potential investors to check title to real estate assets and to identify most potential encumbrances over the same with a high level of certainty. Searches of the registry are usually carried out by public notaries or surveyors, who upon completing their searches issue a report certifying: *(i)* the existence of a title of ownership for the current owner of the asset; *(ii)* the existence of mortgages, liens, easements, other in-rem rights of third parties; and *(iii)* that all transfers during the previous 20 years period have been properly registered with the registry.

The reliability and completeness of such registries allows the potential purchaser to be substantially certain of title to the asset. As a consequence title insurance is seldom used in Italy.

Furthermore, before acquiring a property it is advisable to review at least the latest purchase deeds or any other deed by which the property of the asset has been acquired by the actual owner to identify potential issues mentioned in such deeds.

Regarding other rights (or encumbrances) on real estate assets, from an Italian law perspective, it is advisable to verify the existence of the following:

- (a) voluntary or mandatory pre-emption rights. Pursuant to Italian law *(i)* public authorities have pre-emption rights over properties of historical or architectural interest (such encumbrances can be usually identified through the search in the real estate registry, and for the older encumbrances -which were not registered - through a search with the Ministry of Fine Arts), *(ii)* agricultural tenants or

neighbouring farmers, meeting certain qualifications, have pre-emption rights over farming land, and (iii) non-residential tenants may, at certain conditions, have pre-emption rights over the leased property. Usually breach of a mandatory pre-emption right may involve the right of the jeopardized subject to enforce a compulsory purchasing;

- (b) mortgages (*ipoteche*);
- (c) privileges (*privilegi*), which are *in rem* securities provided by law to secure the fulfillment of certain obligations;
- (d) easement rights (*servitù*), such as rights of way or other burdens on real estate, which may limit the use to which certain real estate assets can be put.

## (ii) Administrative law compliance

For the purposes of verifying the compliance of the asset with administrative law requirements it is advisable to ask for, and analyze, the following documents:

- (a) town-planning certificate ("*certificato di destinazione urbanistica - CDU*") which, regarding the area in which the asset is located: (i) lists the applicable town-planning regulations, and (ii) identifies the eventual existence of certain burdens (for instance, landscape, monumental, architectural);
- (b) a development plan ("*piano di lottizzazione*"), if any, and/or town-planning agreement ("*convenzione urbanistica*"). Please consider that the latter is an arrangement between the owner of a real estate asset and the local municipality, which usually provides for the obligation of the owner to pay certain amounts to the Municipality or to carry out certain urbanization works, and may also provide for limitations to the use and transfer of the area and relevant buildings. Accordingly, in order to avoid any responsibility, it is advisable to verify case-by-case that all the obligations set forth by any town-planning agreement have been duly fulfilled;
- (c) building permits and fit for use certificate ("*certificato di agibilità*"). Any building activity, even if carried out in the context of a refurbishment project (except for certain limited building activity of minor relevance) requires, depending on the type of building works:
  - (i) a building permit issued by the competent Municipality;
  - (ii) the filing, by the owner of the building and/or by the person interested in carrying out the relevant works, of a self-certificated declaration (so-called "*segnalazione certificata di inizio attività*" - "*SCIA*") with the competent Municipality;



- (iii) the filing, by the owner of the building and/or by the person interested in carrying out the relevant works, of a declaration of commencing of the building works ("*dichiarazione di inizio attività*" - "*DIA*") filed with the competent Municipality.

Any building activity carried out in breach of the applicable law provisions may be sanctioned with administrative fines and, in case of major breaches of the applicable building law provisions, with criminal fines and an order of demolition of the works carried out (or part of them). Please also consider that some unauthorized building works may be cured at a later date by means of issuance of building amnesty ("*permesso in sanatoria*") and the payment of the relevant fines; the possibility to apply such an amnesty procedure shall be ascertained case by case in view of the kind of works performed and on the regulations issued by the competent Municipality.

Upon completion of the building activity, the party which has been authorized to carry out the relevant works shall request to the competent Municipality the issuance of a fit for use certificate, which attests the health and safety conditions of a building and that the general compliance of the asset with town planning regulation;

- (d) fire prevention certificate, which can be issued in the form of (i) a fire prevention certificate ("*CPI*") or (ii) a self-certified declaration of commencement of activity ("*SCIA*"), depending on the level of fire risk of the relevant activity. In addition, please note that the CPI is valid for five years and it can be renewed upon expiration.

In addition to the above, usually the investor appoints a technical advisor to check the cadastral identification of the asset, and, in particular, the consistency of the actual building status of the same asset with the relevant cadastral data and with the building titles.

In case of acquisition of an historical building it is advisable to appoint a technical advisor who has specific experience in these kind of assets and in the relations with the various public offices involved.

In fact, one of the issues that most often arises in acquiring historical buildings, especially hotels, relates to the compliance of actual situation of the building with the authorizations, including for fire prevention purposes, and with the cadastral information.

### (iii) **Refurbishment works**

If the investor intends to carry out refurbishment works, it should be aware that especially in relation to historical buildings, planning permissions to be issued by the competent Municipality shall obtain also a prior consent from the competent National Heritage



Authority (“*Sovrintendenza*”) which has the power to authorize the proposed project or give indications/ operational requirements or changes to be followed in the context of the development.

In order to carry out the refurbishment works the investor may appoint one or more contractors. In this respect, it is common practice that investors enter into turn-key agreements with general contractors, which are vested with the full responsibility for the design and refurbishment works for a lump-sum fixed price. Such general contractors will then appoint sub-contractors.

From an Italian labor law perspective, the principal is jointly liable with the contractor for:

- (a) the payment of salaries , social security fees and insurance contributions. The same principle applies also to free lance workers appointed by the contractor;
- (b) for the fulfillment of all the health and safety requirements set forth by the Legislative Decree no. 81 of 2008.

In order to mitigate the liability under (i) it is common practice to agree on the right of the principal to: *(i)* request the contractor to prove the regular payment of salary, social security and insurance contributions to its employees and autonomous worker and *(ii)* retain the sums due to the contractor until the latter gives evidence of the fulfillment of such obligations.

#### **(iv) Hotel activities**

##### *(a) Administrative authorization*

In order to carry out hotel activities, a company does not need to obtain a specific authorization, but it is sufficient to file with the Municipality where the hotel is located a certified statement of starting of the activity (so-called “*segnalazione certificata di inizio attività*” - “*SCIA*”). The SCIA can be applied once the hotel has obtained the relevant category classification (“star qualification”).

The hotel activity can be started from the date of filing of the SCIA.

##### *(b) Hotel management structures*

Based on current market practice few major hotels are operated by the owner of the real estate asset; usually the owner enters into a lease agreement with an operating company which actually carries out the activity, or the hotel activity is managed by a third party (usually an international chain) pursuant to an hotel management agreement.

Lease agreements are the most common contractual structure in cases where the real estate asset is owned by a person other than the person which owns the going concern (equipment, personnel, contract, etc.).

In relation to the execution of lease agreements, please note that Italian law, and in particular Law no. 392 of 1978, provides for several mandatory rules in favor of the tenant (such as provisions on minimum term of duration ((9 years for hotel leases), renewals, termination events, pre-emption right of the tenant and goodwill indemnity at the end of the lease, etc.). Such mandatory provisions can be derogated, for agreements executed after November 12<sup>th</sup>, 2014, only if all the following requirements are met: *(i)* yearly rent of the lease agreement exceeding Euro 250,000, and *(ii)* leased premises not been qualified of historical interest by an order of the relevant region or municipality.

The other commonly used structure in operating hotel activities is the execution of a management agreement with a leading hotel chain, according to which the operator is responsible for the day-to-day running of the hotel (i.e. relationships with employees, accommodation and other facilities, reservations, marketing and promotion of the business, routine maintenance). As compensation for the activities carried out the operator receives a fee, which usually is structured as *(i)* a guaranteed base amount (determined as a percentage of revenue from the hotel business) and *(ii)* a variable amount corresponded proportionally on the base of the performance realized in respect to the target set by the owner.

As an alternative to traditional management agreements, the owner of the real estate asset may decide to operate directly the hotel activity by entering into a franchise agreement with a leading brand company. In this type of agreement the brand company provides the owner with its brand, operational model and required support. As compensation for such services the owner pays a fee usually determined as a percentage of revenue from the hotel business.