INTERNATIONAL ASSOCIATION OF YOUNG LAWYERS

Hotel Projects for the next generation: What are the key factors for foreign investors in order to ensure a successfully running hotel business?

Real Estate Law Commission

National Report of Canada

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Introduction:

In general, new hotel projects nowadays really change the daily life and the face of a city. Suddenly, the city as a whole is upgraded to a new stage of growth and status of prosperity, often combined with spectacular next generation urban architecture style. As a result, and as AIJA people perfectly know, 21st century networking, recreation, business and socializing places are born that inspire us and often allows us to celebrate unforgettable events as a genuine leap into the future of our profession.

For the Annual Congress 2015 in London, the Real Estate Commission is planning to prepare a Workshop with the hot topic *"Hotel Projects for the next generation: What are the key factors for foreign investors in order to ensure a successful running hotel business?"*. Our aim and wish is to compare and share views from different jurisdictions with regard to transactions types, market situation, legal and common hotel business structures and, last but not least, we would like to discuss the effects of the financial crisis in that context.

Below you will find a list of questions related to these aspects. Please try to answer as many questions as possible. If you have any questions, please do not hesitate to contact the responsible General Reporters!

BACKGROUND

Before delving into the details of the hotel business specifically, I will set out an overview of the legal framework within which real estate investment occurs in Canada.

Applicable Law

Canada has a federal system of government. The Canadian federal state consists of a federal government, 10 provincial governments and three territorial governments, each with its own sphere of legislative competence. Additionally, the provincial governments may delegate legislative authority to local municipal governments.

Ownership of real property in Canada is governed primarily by provincial and territorial legislation, although there are also federal laws, such as the Goods and Services Tax, income tax, environmental protection legislation and foreign investment legislation that will apply.

Based on the division of powers set out in the *Constitution Act, 1867*, the federal government has jurisdiction over matters of national importance, while the provinces have jurisdiction over matters of local importance. With certain exceptions, real property is considered a matter of provincial jurisdiction, and each province governs the acquisition, ownership, use and development of real property within its boundaries. Such exceptions include lands reserved for Canada's aboriginal people and federal ports and harbours which fall within federal government jurisdiction. Other than in the Province of Québec, which is governed by the *Civil Code of Québec*, real property law in all other provinces has evolved from English common law principles.

Financing

In Canada, real estate financing can be structured in a variety of ways, including:

- conventional mortgage lending;
- public and private capital market financing;
- portfolio loans;
- acquisition financing;
- permanent financing;
- public and private bond financings;
- syndications;
- restructurings; and
- securitization.

Banks, pension funds, credit unions, trust companies and other entities all arrange such financing on credit terms that vary on the basis of the transaction itself and the risks involved. Various rate and term combinations are offered.

Security over Real Property

There are various instruments used to take primary security over real property in Canada, such as a mortgage or charge, a debenture containing a fixed charge on real property and trust deeds securing mortgage bonds (where more than one lender is involved). Additional security usually includes assignments of rents, leases, and other contracts, guarantees and general security agreements.

Most real estate financings are arranged through institutional lenders such as banks, trust companies, pension funds, credit unions and insurance companies. Credit terms will vary between institutions and will be reflective of the nature of the transaction and risks involved.

Generally, lenders will not provide financing in excess of 75% of the appraised value of a property.

Because many foreign lenders in Canada are subsidiaries of international banks, they frequently participate by way of syndicated loans arranged by a Canadian lending institution.

Lending institutions typically take both primary and collateral security in real property and related assets; Primary security includes: a mortgage or charge; a debenture containing a fixed charge on real property or, in some cases where multiple lenders are involved, a trust deed securing mortgage bonds or debentures and including a specific charge over real property. Collateral security often includes: assignments of leases and rents; assignment of material contracts; general security agreements; and third party guarantees.

Upon default in payment under any such mortgage or instrument, a creditor may sue the debtor and, in most cases, subject to compliance with legal procedural requirements of the particular jurisdiction, may sell or foreclose upon the interests of the debtor and subsequent holders of security interests in real property. As a result of the ability to register any number of security interests against a particular property, statutory rules (which are usually based on the order of registration under the applicable registry or land titles systems) exist to determine priority among lenders.

Real Estate Investment Trusts (REITs)

REITs are becoming more and more popular nowadays in Canada.

A REIT is a security that sells like a stock on the major exchanges and invests in real estate directly, either through properties or mortgages. REITs receive special tax considerations and typically offer investors high yields, as well as a highly liquid method of investing in real estate.

REITs have their roots in a mid-1990s amendment to the *Income Tax Act* (Canada) that allowed closed-end mutual funds to hold real estate. They are required to be configured as trusts and are not taxed if they distribute their net taxable income to shareholders. REITs were excluded from the income trust tax legislation passed in the 2007 budget by the Conservative government.

The Bloomberg Canadian REIT index has returned about 12% over the last year. Their yield remains at an attractive level of just under 5%.

The current low-interest environment is doubly beneficial for REITs. In addition to providing a solid base for the real estate market, they also make REITs attractive for yield-seeking investors who lack alternative investments that produce similar high yields.

Canada generally has high real estate occupancy rates and rising rental rates. Those factors, along with an accommodating interest rate, and a disciplined and prudent development industry, have kept supply of new property constrained, despite relatively strong demand.

Canadian developers learned their lesson after getting stung by oversupply in the 1990s real estate slump. Since then, a conservative approach to development has helped keep the real estate market hot across sectors and across the country.

Canadian REITs have recently begun to look beyond Canada's borders. This is due to elevated investor demand for REIT products. There is only a limited amount of income-producing Canadian real estate and thus Canadian REITs have begun look to the U.S. and elsewhere in the world for property acquisitions.

In terms of hotels, there are several examples of Canadian REITs, such as American Hotel Income Properties REIT LP (TSX:HOT.UN), whose $96 million IPO occurred in 2013, which has built its business on indirect ownership of hotel properties that focus on railroad employee accommodation across the United States.

I.- MARKET SITUATION / TYPE OF TRANSACTIONS / MIXED USED TYPE

1.- Give a brief overview of the hotel sector market situation in your country (or region): Specifically, what are the current trends and/or what are the main targets for investors? What are the general expectations for the near future?

As of 2013, the most recent year for which statistics are available, there were some 8,500 hotels, motels and resorts in Canada boasting revenues of $17.6 billion, employing more than 290,000 people and generating tax revenues of $7.4 billion. Overall, the Canadian travel and tourism industry accounted for $84 billion in economic activity in 2013, $17.36 billion in export revenue, $9.6 billion in federal tax revenue and employed more than 614,000 people across Canada.

The outlook for hotel investment in Canada is positive. It is expected that there will continue to be strong investment in the sector in light of low interest rates and a positive outlook for GDP growth. Investment in Canada's hotel sector typically tracks the rate of growth in GDP.

That said, the hotel business is not an easy one. It's a very operational business that requires a high level of expertise. It combines aspects of the business and leisure markets. Branding is an important aspect. Investors also need to deal with the factor of seasonality.

Investments in boutique hotels are growing. For years, it was seen as necessary to have a "flag" of a well-known hotel chain in order to gain access to the chain's reservation system. However, in this age of the Internet, when even the smallest hotel can be listed on Expedia, the "middleman" (i.e., the huge international chains) can now be cut out. The familiarity of a chain hotel experience is admittedly a source of comfort to some guests, but to the many increasingly sophisticated travellers in the market who are seeking a unique experience and who can easily check TripAdvisor reviews and the like, there is little need for the flag of a major brand on a hotel.

The "crowdsourced" lodging and hospitality market (e.g., AirBnB) is another factor for investors to consider – particularly those looking to buy or build limited service hotels.

Institutional investors have been buyers of prime hotels in Canada's key markets recently. Pension funds tend to hold assets and are very selective in the hotel space. This differs from opportunity funds/ private equity groups who tend to not have an attachment to assets; they are driven by their fund's objectives, which is typically a 5-to-7 year hold/payout/redeploy model.

2.- What type of transactions are the most usual in your jurisdiction (development, purchase, sale, lease, management agreement, sale & lease-back, franchise, etc.) ?

- Canadian hotel trading volume reached over $1.4 billion in 2014, the second highest since the last peak in 2007.
- Full service assets dominated volume with headline sales including the Park Hyatt Toronto, Hyatt Regency Vancouver and the Fairmont Empress Hotel (in Victoria, British Columbia).
- Transaction activity was supported by an elevated level of buying and selling amongst institutional investment groups.

3.- Are there mixed use types (Hotel & Residential or Resort/Relaxing facilities, condo-hotels/condominium, etc.)? If so, please describe some typical schemes you know about or which you find interesting to share. Please describe pros & cons, if so, of one structure compared with others.

Condominium Hotel

The legal structure used to create a Condominium Hotel tends toward three fundamental structures. They are: (i) a traditional condominium, with unit owners owning and controlling the entire project, including the facilities necessary to operate the hotel; (ii) a condominium in which the facilities that are necessary to operate the hotel are placed in a separate shared facilities unit, which is owned by the developer and managed by a hotel operator; and (iii) a building which is subdivided into separate components, with one component comprising the condominium, consisting primarily of hotel rooms owned by individual unit owners, and the rest of the building owned by the developer as a separate parcel of real estate, in which most of the improvements and facilities necessary to operate the hotel are located.

A Condominium Hotel is first and foremost a hotel, and to succeed, the project must achieve occupancy levels and room rates that are competitive with the local market. A hotel has many different and unique elements required for successful operation, and carries with it categories of cost that differ from traditional residential condominium projects. To the extent that the hotel is not successful, the individual unit owners typically bear the cost of any operating expense deficiency.

Joint Ventures

Using a joint venture model for hotel acquisitions offers the benefits of increased access to capital, sharing of risks and rewards with a partner, access to greater resources, such as specialized staff, technology and expanded relationships. Particularly in the current economic environment where traditional lenders may be reluctant to invest new capital in the hotel business, a joint venture with

partners already active and committed to the hotel business offers an alternative means of financing potential future business expansion.

A joint venture is often created through the formation of a new entity, most often either a general partnership, a limited partnership or a corporation. The rights and obligations of the parties to the joint venture are governed by the partnership agreement or shareholders' agreement entered into by the parties as investors in the new entity.

The partnership agreement or shareholders' agreement provides the full details of each party's specific obligations, with timelines for performance, as well as specific steps that can be taken by the aggrieved party when the other party fails to fulfill its obligations.

4.- Is the off-plan project always a common scheme to follow or is it an out of date concept?

Off-plan projects, or pre-sales, are popular with investors and other buyers because it allows these buyers to have the benefit of increasing prices without having to pay a mortgage, property taxes, maintenance fees, or deal with troublesome tenants. Pre-Sales also allow owner occupiers the ability to customize the property they buy.

Are Pre-Sales Safe?

In the Province of British Columbia, where pre-sales are common, pre-sales are regulated by the *Real Estate Development Marketing Act* and are generally safe when you are buying from a reputable developer. (Other provinces do not have a legislation dealing specifically with pre-sales).

Facts about Pre-Sales

1. The Purchaser of a pre-sale has the right to walk away from the contract to purchase the property *for any reason* for seven days after there is an accepted offer. This a British Columbia provincial law known as the "Seven-Day Rescission Period" under which you can cancel your investment for any reason – be it failure to obtain financing, or even if you can't sleep at night after making the investment!

2. All deposits paid by the buyer of a pre-sale are held in a lawyer's trust account. This money stays in the account until the building is either built or the developer fails to meet the time deadline to have the building built. The developer cannot use this money and does not have access to this money until the building is complete. If the developer goes under, the money in the trust account is not part of the bankruptcy and has to be returned to the buyer.

3. The Disclosure Statement, required by law will have all of the important info about the property you are buying such as the size of your suite, what will be included in the suite, and what the building will look like.

5.- Are new projects involving renewable energy popular in your country? Are those more attractive than standard projects even though they are more expensive? Do they involve lots of clauses which can be considered "*condicio sine qua non*" for the signing of the contracts?

Investment activity on large solar projects is taking place mainly in the province of Ontario, where pro-renewable-energy government policies essentially subsidize solar installations. This trend has not been duplicated in any other province. Without government support, solar projects elsewhere will likely continue to remain small scale, until dropping panel prices allow the industry to compete with other forms of power.

This flurry of activity in large-scale solar is a direct result of Ontario's public policy on renewable power. The province's *Green Energy Act,* passed in 2009, was designed to boost renewable energy development – and the industry that supports it – by paying high prices for electricity generated from wind, solar and other clean sources.

Under that "feed in tariff" (FIT) program, the owners of a recently-built project, for example, will receive 44 cents a kilowatt hour for all the power it generates over the next 20 years, about three times more than the retail electricity rate of less than 14 cents a kilowatt hour.

Canada still sits behind the United States, however, where 4.7 gigawatts of solar were installed in 2014 alone. In the U.S., 33 per cent of all new electricity generation installed was solar. Of course, Canada's miserable winters are less conducive to sunny days …

As for the hotel business specifically, energy-efficient and renewable energy technologies offer wide applications in the hotel industry. The adoption of these technologies improves energy performance and reduces dependence on fossil fuels. Hotel organizational commitment towards sustainability is highly inconsistent across the industry. Essentially, this industry represents a continuum of adopters; some hotels are leaders who proactively adopt innovative and state-of-the-art technologies, while others adopt only basic practices, such as reusing towels. Sharing best practices and learned lessons is essential to convince less committed hotel organizations to take action.

6.- Lawyers and Project Managers: Do they work well together or is there friction between them?

There is no reason why Canadian lawyers and property managers should not be able to work together. Property managers often require the services of a real estate lawyer to manage their legal conflicts, as well as buying, selling and other transactions. It is common for a real estate attorney to write up contracts for tenants, write up legal forms for termination of leases and to handle a title search on a potential property that the property manager wishes to purchase.

Real estate legal jobs will always be important positions. Regardless of the real estate industry's movement, the job of an attorney to file foreclosure papers, to enable a short sale and to do other tasks is always warranted.

In fact, those real estate lawyers working in private practice may find that they have the largest demand currently as many companies are outsourcing work to these attorneys instead of hiring a fulltime attorney to hold the position.

7.- Are there favourable tax or other promotion plans for resorts for elderly people in your country?

Canada has an aging population, which means that seniors' housing presents a positive investment opportunity. Vacancy rates are low and returns can be strong. Some investors choose to partner with firms that specialize in facilities management, rather than taking on responsibility for operations themselves. Investors should also be aware that there are differences in business models and investment perspectives between independent-living facilities and long-term care or convalescence facilities.

II.- BUYING AND SELLING THE HOTEL BUSINESS: PLEASE DESCRIBE THE MAIN SCENARIOS WHEN IT COMES TO A HOTEL ASSET OR SHARE DEAL SITUATION.

1.- Please describe the pros & cons or simply the differences to keep in mind when the "Hotel Business" changes ownership – the answers may contain legal as well as practical aspects.

Hotels are unique real estate investments that carry a certain level of investment risk, but also high rewards. Compared with traditional commercial real estate, hotel investments carry a higher level of capital and labour intensity, making hotels a hybrid of both real estate and operating businesses. On the one hand, hotel rooms are perishable products that add volatility risk to the investor, while on the other hand, accommodation-related investments benefit immediately from economic growth - unlike commercial real estate that is locked into long-term leases.

Hotels are only partly real estate. The other part is an operating business. Thus, while you no doubt need to understand the cornerstones of buying good real estate, such as location, marketable title, environmental hindrances, sufficient structural and building systems, and so forth, you also need to understand how to make that hotel operate smoothly for your purchase to be a good investment. While some investors will buy a hotel simply looking for costs to cut, causing an immediate increase in the cap rate, that solution does not work for long.

All the right elements have to be in place for a hotel's business to succeed in a sustainable manner. The hotel needs to have the right legal and business team and proper management structure. It is essential to hire the right hotel manager at the outset. The right management team will clearly understand the particular market segment for the hotel, how to market the hotel, how to enhance revenue and contain costs. A solid management team will know how to improve the value of the hotel.

2.- In cross-border situations: Tell us about your experience or lessons learned when it comes to local differences and how to deal with these situations (e.g. are there some peculiar legal or cultural aspects, which investors should keep in mind when they want to invest in hotel business in your country?)

Purchase of Real Estate by Foreign Buyers

Foreign investors are increasingly snapping up stakes in Canadian hotels, attracted in part by a relatively stable economy and an increase in buying opportunities. This growing foreign interest stems from Canada's reputation as a relative safe-haven in the wake of the financial crisis, because success in the hotel business is highly tied to the local economy.

Pursuant to the *Citizenship Act* (Canada), a non-resident can acquire, hold and dispose of real property in the same manner and under the same conditions as a Canadian citizen or resident.

However, the provinces have the right to restrict the acquisition of land by people who are not citizens or permanent residents, or by corporations and associations controlled by them.

In the Province of Ontario, the *Aliens' Real Property Act* grants non-citizens the same rights as Canadians to hold or dispose of real property. Under the *Extra-Provincial Corporations Act*, a corporation incorporated outside of Canada must obtain an extra-provincial license to acquire, hold or convey real property in Ontario, but such licenses are easily obtained.

In Québec, pursuant to *An Act respecting the acquisition of farm land by non-residents*, non-residents of Québec are not permitted to acquire farm land, unless they receive the authorization of the *Commission de protection du territoire agricole du Québec,* the authority in charge of preserving agricultural land in Québec. Some other provinces have similar restrictions to preserve agricultural land.

3.- Have you had lots of M&A transactions involving Hotel Projects in your country in the last two years?

Hotel transaction volume climbed to over $2 billion in 2013, up 72% year-over-year and taking place as the third-highest year on record after 2006 and 2007. The market was flush with capital and the strong and diverse rotation of buyers and sellers saw an opportune time in the cycle to take advantage of current conditions.

Other trends in Canada’s hotel industry:

- New supply of guest rooms has remained below historical norms (2.0%-2.5%), but is expected to pick up momentum into 2015 and 2016.
- The availability of rarely offered prime city centre hotels in Canadian gateway cities is attracting institutional capital.
- Acquisition for alternate use: There are select opportunities where the asset has reached the end of its lifecycle as a hotel. Appetite for conversion to student residences and redevelopment to residential exists.
- There is a substantial market in Canada for partnership buy-outs, refinancings and new joint ventures.
- In January 2015, the Bank of Canada lowered its already historically low overnight lending rate by a quarter of a percentage point - from 1.0% to 0.75% - and a further reduction is widely expected. There is thus ample supply of mortgage capital available for hotels, which forces lenders to be more aggressive on both underwriting standards and pricing.

- The Canadian dollar has declined in value from par (i.e., US$1.00) recently to approximately US$0.80 at present. This "cheapening" of the Canadian dollar, which is expected to continue somewhat over the coming year, at least, will make hotel acquisitions by foreign buyers (specifically from the U.S.) more attractive.

III.- HOTEL BUSINESS STRUCTURE - MANAGEMENT AGREEMENT/LEASE AGREEMENT/FRANCHISED OR ALL MANAGED BY THE OWNER?

1.- How would you describe the usual hotel business structures in your country. Who are the key parties/players involved and who is responsible for which part of the running business? (For example, in case the owner is responsible for everything, that means he owns the building and also owns & operates the hotel business – please give a short overview.)

In a traditional hotel management agreement, the property owner appoints an operator to run the hotel for a management fee, often calculated as a share of the turnover. In some cases, the hotel owner also pay an additional incentive fee based on the hotel's profit, but that is normally a smaller part of the total fee.

Under the typical structure of a management agreement, the property owner shoulders all investment costs in the property, leaving him in a position where he has full financial responsibility for operations, as well as investments, while the operator – who is in control of the value chain – shares any upside, while avoiding risk and investment costs.

Hotels are more than just real estate. The value of the hotel depends highly upon the hotel's business. The hotel business depends on the following factors, among others:

- Labour and employment
    - Are hotel workers unionized?
    - How is employee morale? It is costly to have to replace hotel workers.

- Hotel brand
    - Brand owners have to approve many changes to a property.
    - Is the current brand the right one for that property?

- Hotel systems
    - It can be costly to have to implement new revenue management and cost containment systems, reservations systems and booking engines.

2.- In the event of a management agreement, i.e. the owner owns the building and the hotel business, what are the most important clauses or aspects to be structured or dealt with (duration, fees, liability of the management, operating risks, etc.)?

The Hotel Management Agreement, or HMA, is one of the clearest separations of ownership and operation of a hotel. A branded HMA with one of the traditional hotel management companies is typically a long-term agreement between the owner and operator, under which the operator is delegated virtual control over the operations of the hotel. For hotel owners and operators, finalising the hotel management contract is a game of sharing risk and reward.

When signing a hotel management contract, hotel owners and operators will naturally pursue their interests. Agreements must be structured to motivate parties for long-term performance.
This requires flexibility, risk-sharing, accountability and aligned interests.

This document is extensively detailed, normally 40 to 100 pages and details many other terms such as confidentiality, IP and other terms.

The principal provisions in an HMA include the following:

- Term
- Operating Fees and Charges
- Operator Guarantees
- Performance Measures of the Operator
- Budget Procedures
- Required Owner Approvals
- Required Capital Expenditures
- Non-Compete Clause
- Dispute Resolution Procedures
- Indemnifications

Other terms for negotiations can include:

- Personnel – who will employ the hotel's staff and general manager selections?
- Expenses – what's the budget, reserve percentage and any expenditure limits?
- Reporting – structure and frequency of financial, operating and other reporting
- Territories – any geographic and time restrictions for additional hotel openings
- Marketing – overhead and per unit cost for centralized services and functions

Termination Clauses

Major-brand HMAs have historically had base initial terms of 20 years or longer, with rights of renewals or extensions in multiples of five or 10 years. As a result, many branded HMAs have effective terms of 60 years or more. That said, in modern hotel management contracts with branded operators, terms have decreased. The parties might negotiate a 15-year initial term, plus two 5-year rollovers. With independent non-branded operators, initial terms may be five-to-10 years. Negotiations often turn on the granting of desired termination rights and fee flexibility.

Since the brands typically no longer own the hotels, the brands' business models are built upon their inventories of HMAs and the anticipated revenues to be derived from them - virtual annuities. Understandably, the brands have become extremely protective of their inventories of HMAs. As much as possible, brands have made, or have tried to make, their HMAs irrevocable contracts.

Given the long-term duration of HMAs, the up and down cycles in the economy and in the lodging industry, at some point, disputes will inevitably arise between the owner and operator. The problems arise from the tensions brought about by the separation of ownership and management. Operators no longer have to pay for the maintenance or repositioning of the hotel real estate. They are paid virtually all their fees "off the top" (based on gross revenues) whether or not the owner derives any profit. Operators also have an interest in building their brand value and guest loyalty, without regard to return on the hotel owner's investment. The risk and reward of hotel ownership has been fundamentally alienated from hotel management and branding.

While many disputes are anticipated and are provided for in the dispute resolution provisions in the HMA - such as mini-arbitrations before specialized experts over capital expenditure requirements, budgets, design issues, and the like - other disputes go to mediation and if not resolved, to arbitration or litigation. Absent a specific right to terminate, such as a failed performance metric, terminations could be contractually prohibited.

On reading the plain language of a typical HMA, the owner might conclude that, without a failed performance metric or applicable termination event, there is no way to terminate the operator. The owner seems stuck within a failed relationship with an operator. But as HMAs and their no-cut provisions have been tested in the courts, owners and operators have found that certain onerous provisions in the HMAs are not enforceable.

Nowadays, a hotel management contract might permit termination pursuant to terms such as:

a) Termination without Cause

The ability to terminate the hotel management contract without cause is extremely rare. It can impact operator motivation to perform. Powerful owners might seek this benefit but realistically, only independent and few operators would agree to this (to close deals).

b) Termination on Sale

To maximize the potential buyers when selling their hotel, owners may seek options to terminate the hotel management contract. Operators might secure the right to first offer and 20 to 60 days exclusivity to reach agreement, before owners attempt to sell out.

c) Performance Termination

When signing a HMA, an owner is buying expertise and hence, might demand rights to terminate deals if operators can't achieve agreed performance. For example, terms might say termination rights trigger if the operator fails to achieve 90% of forecasted gross profit for two consecutive years (or trailing 12-month periods).

Equally, operators want protection from market dynamics. Instead of forecasted profit, terms might require comparisons across RevPAR, or Revenue per Available Room, results in hotel competitive sets.

Base Fees

The hotel management contract base fee is typically negotiated after the incentive fee. It's often 2% to 3% of the total hotel revenue, depending on the parties and other terms.

Incentive Fees

In HMAs, variations of incentive fee structures may be used:

- Historically, incentive fees of 8% of gross operating profit might be agreed. The hotel operator is motivated to increase profit to increase their base and incentive fees, but they aren't worried (at least contractually) about the owner's percentage return goals.

- Alternatively, hotel management contracts may use a 'priority return' in the incentive structure. If the owner wants a 7% return on investment, this might be agreed and paid from the cash flow, before an operator receives their higher incentive fee (say 20% to 30%). When operators take higher risk on incentive fees, they'll want higher base fees.

3.- In the event of a lease agreement, i.e. the owner owns the building but not the hotel business, what are the most important clauses or aspects to be structured or dealt with (duration, rent, early termination rights, change of control clauses, pre-emption rights, etc.)?

A hotel owner might sign a hotel lease agreement with an interested operator. It's an option for control and branding of their hotel and works like any tenant-landlord setup (i.e. the tenant gets "quiet enjoyment of the property", the landlord gets management).

The owner receives the rental income but normally can't intervene in hotel operations.

The leasing operator absorbs 100% of the financial risk. Even if markets dive or cash flows decrease, hotel lease agreements will still require rental payments to owners.

The lessor (owner) and lessee (operator) have obligations and rights. The objective is to avoid moral conflicts – no party should have incentive to underinvest or underperform.

* * *

The following are some terms typically found within hotel lease agreements:

Hotel Rent Payment

Rents could be fixed, variable or hybrids in hotel lease agreements. Fixed rents are typically increased annually by inflation. Variable rents are likely based on total hotel revenues. If using a hybrid rent, a tenant might pay the higher of the fixed or variable.

Term of the Lease

The standard lengths for hotel lease agreements will differ country to country. Frequent minimums are 20 years, though 30 to 40 years is common. Hotel operators are investing in the long term – as building awareness and stabilising cash flows takes time.

Capital Expenditure

Hotel lease agreements must specify which party is responsible for major expenses (i.e., the building structure, boiler and pumping systems, roofs and elevators). These items are typically the responsibility of the owner. The hotel lease agreement might require them to reserve 2% of revenue for facilities maintenance. In exchange for lower rent, some hotel operators might accept this responsibility – but that's a major financial risk.

Other Maintenance

Unlike major capital expense maintenance, lessee operators are likely responsible for regular maintenance of the internal building bones. Owners will check on maintenance.

Lease Renewals

In hotel lease agreements, the lessee operator commonly decides whether to renew.

Furniture, Fittings & Equipment

The parties must specify FF&E ownership in hotel lease agreements. Options exist:

- The tenant brings the FF&E, they own it and they're responsible for replacement
- The tenant receives the owner's existing FF&E. When the lease ends, they return an equivalent amount plus inflation. The tenant is responsible for replacements.

If owners are required to replace FF&E from breakage and wear-tear scenarios, the hotel operator will always want more. Either way, an FF&E reserve should exist in the hotel lease agreement, ideally between 3% and 5% of the hotel's revenues.

Sublet and Assignment

This right is infrequently granted. Hotel owners want to lease their asset to screened, known and professional operators, for specific reasons. Allowing sub-letting might help the operators risk management, but it's definitely not in the hotel owner's interest.

Rent & Security Deposits

Hotel lease agreements require bonds. It's often one to two years of rent. As it involves huge amounts, many owners accept letters of credit or guarantors instead of deposits.

Insurance

The hotel operator (lessee) generally must carry public liability insurance on the building. Acceptable minimum levels of insurance coverage are agreed in the deal negotiations.

Standards & Audits

Depending on their reasons for hotel ownership, an owner may only want to lease to specific hotel operators. They want assurance that brand standards are maintained.

It's a tricky clause in hotel lease agreements. The operator controls brand standards across their network and given they're permitted 'quiet enjoyment', reporting creates extra workload. Owners might require monthly, quarterly or annual 'quality' reports.

That's different to hotel management contracts, where reporting is daily and weekly. If audits are agreed and violations found, the lessee operator may need to reimburse.

Hotel Purchase Options

As operators are 'creating value', they should want the option (which they may never use) to purchase the asset built into the hotel lease agreement. A purchase option could be exercised as negotiated – either at the end of the lease term or a specified period. It's likely the operator would acquire the hotel, then action a sale-leaseback strategy. Hotel owners naturally aren't eager to lock-in advance purchase options (especially in recovering or booming real estate and tourism markets), but many will agree to this.

End of the Lease

The hotel lease agreement should reinforce obligations for the last years of the lease. If the lease isn't being renewed, the lessee operator might tactically underinvest or limit maintenance. Some might even shift business to another nearby hotel they operate.

* * *

The following are the main types of hotel lease agreements:

Revenue-based

Revenue-based hotel leases are linked to sales generated by the hotel business. To limit the risk, these leases often specify a minimum rent (guarantee/base rent).

Result-based

A result-based hotel lease implies that the hotel property owner receives a share of the hotel operator's operating net profit. This type of lease requires that the hotel property owner understand the operator's financial control system. Results-based hotel leases can also specify a minimum rent (guarantee / base rent).

Fixed-fee hotel lease

Fixed-fee hotel leases with an index linked to the development of the Consumer Price Index (CPI) are used in mature markets and in well-established hotel products. A fixed-fee lease limits the risk factor, but also the potential.

4.- In the event of a franchise system, what are the most important clauses or aspects to be structured or dealt with (contractual relationships and parties involved, etc.)?

The reputation, name and standard level of a brand owner and the expense restrictions of the hotel owner are key elements in negotiating a franchise agreement. Under a franchise agreement, the hotel owner gains the benefits of brand strength and presence with the potential for a lower cost.

Here are some terms typically found within hotel franchise agreements:

1. **Franchise and Royalty Fees.** While it's unlikely that franchise fees will be reduced for the entire term of the agreement, a "ramp up" in fees over the initial years of the agreement, particularly for a newly built hotel, can often be achieved. While other chain fees are more difficult to negotiate, it can be possible to get some temporary relief there, as well.

2. **Area of Protection or Non-Competition.** Hotel owners are properly concerned about the brand opening a competing hotel within their property's market area. If it's not offered, a franchisee should ask during the negotiations for a geographic area of protection or non-competition. The length and breadth of the restriction varies, but some protection is usually granted.

3. **Ownership Transfer.** Most franchise agreements are still based on a simple ownership model, contemplating a single owner (or investment group) of a single hotel. More sophisticated owners (including REITs, private equity groups, real estate funds and other institutional investors) are increasingly focused on hotel investments. As a result, the transfer provisions should consider the structure of the owner and flexibility for transfers to certain related parties. In that regard, while a sale of a hotel often precipitates a property improvement plan, or PIP, the owners should not trigger a new franchise agreement negotiation, set of franchise application fees and PIP when the transfer is to a related corporate entity or to another family member or trust set up for estate planning purposes.

4. **Independent Management and Changes in Management.** The essence of franchise structure is providing the power of a brand with the greater flexibility and responsiveness of an independent operator (i.e. an operator unrelated to the brand). A good independent operator can provide an owner with a valuable buffer to the brand's demands for operating and capital expenditures, implementation of new and expensive brand standards, property improvement plans and certain brand programs that may not make sense for a given property. While brands are, understandably, concerned that an operator must have the experience to run the property, the management company should be the owner's choice, and should have primary loyalty to the owner, not the brand. Thus, it's important to prevent a franchisor from having veto power over change in management of the hotel.

5. **Liquidated Damages.** Liquidated damage provisions in the franchise agreement give the franchisor the ability to collect damages on the early termination of the franchise agreement. They can be a key inhibitor to the owner's ability to maximize the value of the property on sale, because liquidated damages have ballooned in recent years to as much as five times the average combined franchise fees and reimbursements paid to the franchisor. There are usually ways to both reduce the amount of the damages as well as restrict the potential transactions that might trigger payment.

6. **Capital Investments.** Franchise agreements usually give the brands the ability to require substantial additional capital investments by owners to meet new physical brand requirements. There are a number of ways to reduce an owner's exposure, including restricting time periods and clarifying the types of capital improvements that can be required. This is particularly the case for a newly built property or an acquired property that may have recently undergone renovation.

7. **Personal Guarantees.** Most franchisors require guarantees. Owners should seek to eliminate, or at least restrict the scope, of guarantees. As more and more owners are institutional, this requirement is less and less meaningful.

8. **Key Money.** For the last several years, many brands have been willing to provide key money as a means of securing franchise agreements. While owners are typically excited about the prospect of getting additional funds, they should remember two things: First, key money is typically only paid after the hotel opens; it doesn't provide funds for construction. Second, and more importantly, key money is probably the most expensive money an owner will get; in return for key money, brands typically will be even less willing to negotiate important franchise agreement provisions.

While there are limited areas that a hotel owner can expect to successfully negotiate with a brand in a franchise agreement, changes in these limited areas can make a big difference in the value of the brand to the owner.

5.- Please describe which are the most common financial leverage or instruments to be arranged by the builders or investors?

Numerous financial institutions provide hotel financing in Canada via mortgage loans. The typical loan to value ratio is 60% ranging from 50% to 70%. Required debt coverage ratio is 1.1, but can go as high as 1.55. Typical amortization rates are 20 years, but can go as high as 25 years.

The current low-interest-rate environment (described above) makes borrowing attractive to hoteliers looking to expand or refinance their existing hotels portfolios.

6.- Is a private equity scheme more common than traditional bank loans in your jurisdiction?

No. Canada has a healthy banking system and it is common for loans to be taken for the purpose of real estate development, including the development of hotels.

IV.- EFFECTS OF THE FINANCIAL CRISIS

1.- Please describe the effects of the financial crisis in your jurisdiction, if any. Are there a lot of forced sales scenarios? Give examples.

Unlike the United States, Britain, Ireland, Germany, France, Japan and any number of other countries, Canada escaped the financial crisis relatively scot free. Canada did not experience a housing bubble.

Why didn't Canada have a Financial Crisis?

Canada's banking system is substantially different from that of the United States and has been for nearly 200 years. Canada's banking market is oligopolistic and tightly regulated. By comparison the U.S. banking system is fragile, crisis-prone, and highly politically entrenched. The Canadian system did not experience a crisis in 2007-2008.

Starting in the 19th century, Canada and the United States took divergent paths: Canada set up a concentrated banking system that controlled mortgage lending and investment banking under the watchful eye of a single, strong regulator. The United States allowed a weak, fragmented system to develop, with far more small (and less stable) banks, along with a shadow banking system of less-regulated securities markets, investment banks, and money market funds overseen by a group of competing regulators

Canada has no Fannie Mae and no Freddie Mac. There is no mortgage interest tax deduction. There are no 30-year fixed-rate home loans that can be freely refinanced and prepaid. Mortgage lending in Canada is far more conservative, and Canadian mortgage lenders have a lot more recourse than American ones.

If Canadian homeowners default, their other assets and income are on the line, not just the property. Strategic defaulting is not an attractive option.

There is more incentive to pay down mortgage debt because there is no tax deduction for interest paid on home mortgages. Canadians mostly pay their mortgages electronically and automatically from their chequing accounts - so extra effort must be made to actually miss a monthly payment. Canadian fixed-rate mortgages generally come with anti-refinancing prepayment penalties to protect lenders from interest rate drops, and the mortgage interest rates on these loans are fixed for a maximum of five years - an incentive to pay the debt down faster.

While these provisions aren't so friendly for consumers, they ensured that Canadian banks survived the international financial crisis without requiring a taxpayer bailout. Furthermore, Canadian neighbourhoods and individual homeowners have not been destroyed *en masse* by property bubbles burgeoning and bursting. Canada didn't completely sidestep the recession, but home loan default rates are much lower than in the U.S., where one-in-10 mortgages is in trouble.

Also, Canada has a single consolidated financial regulator rather than the fragmented system of the United States. The sovereignty of U.S. states is somewhat different than the sovereignty of Canada's provinces.

2.- Financing of hotel transactions – how does that work nowadays? (Which are the most obvious differences in contrast to earlier times? Which expectations and requirements do Banks have at the moment?)

No change. See response to #1.

3.- Litigations matters: Are many of the failed transaction resolved by arbitration or is traditional litigation used in your jurisdiction?

Either can work. Our court system is fairly efficient in Canada. However, arbitration offers even greater speed and confidentiality.

4.- In case a criminal proceeding is involved: Is there also a way to protect third parties involved without awaiting the decision of the Criminal Court?

A civil proceeding must be taken in court. Courts are able to grant injunctions when urgent in order to prevent further losses from occurring while the parties wait for other proceedings (including criminal proceedings) to unfold.

5.- In your opinion: Is the crisis also a financial opportunity for speculators who can invest in "unfinished projects" with few resources?

Not really applicable. See response to #1.