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# Papers

## What happens on the expiry of a hotel lease?

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### Abstract

What happens at the end of a hotel lease may not appear to be a priority when negotiating the terms; however, time spent considering this at the outset will be time well spent.

### Keywords:

hotels, leases, TUPE, FF&E, capital expenditure, tax, bookings

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### INTRODUCTION

Record numbers of hotels have changed hands over the last couple of years. Many sold by the big hotel operators have been the subject of manage back deals using management agreements. A significant number, however, has been the subject of leasebacks or new leases. Although the large hotel operators may prefer management contracts, many investors prefer leases, so the hotel lease is likely to remain with us for the foreseeable future.

People negotiating heads of terms for a lease have many details to think about and what happens at the end of the term may not immediately appear a priority, not least because, as hotel leases are often for long terms, the original negotiators may no longer be around to deal with the issue. In addition, of course, most property leases merely oblige the tenant at the end of the term to 'yield up' the property in good repair.

Leases of hotels, however, should be different from the leases of other property assets because hotels form a distinct and very different property asset class. The bricks and mortar of the structure and the hotel business operating from it are two sides of the same coin and the state, condition, and value of each impacts closely on the other. To maintain value, to avoid significant potential costs, and to smooth management issues, time spent at the outset in agreeing what happens when the lease comes to an end will be time well spent.

Some leases grant the hotel tenant the right to a renewal at the end of the term. In other cases, the tenant may exercise his/her right to a statutory renewal under the Landlord and Tenant Act 1954. On renewal, any termination provisions are unlikely. One cannot, however, assume that

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renewals will go on for ever. At some stage the tenant will move out, perhaps because the landlord wishes to operate the hotel business himself/herself. What will happen to the hotel business then? Many leases remain absolutely silent on the issue. This is potentially bad practice as a few carefully drafted pages inserted at the outset could save considerable time, worry, and expense later.

As the landlord is unlikely to be able to foretell whether he/she will wish to take over the hotel business of the tenant many years hence at the end of the term, the landlord should have the right to choose at that time. If the landlord chooses not to take over the business, the lease should provide that the tenant is responsible for dealing with the redundancy of the staff and should also provide whether the tenant must remove the furniture, fixtures & equipment (FF&E) and other contents so that full vacant possession is provided. Where the landlord elects to take over the business as a going concern, the following (and a number of other) issues will need consideration and appropriate documentation in the lease.

### **STAFF**

If the landlord acquires the business, the Transfer of Undertaking Regulations will automatically pass over the responsibility for staff to the landlord as the new business operator. There may, however, be obligations to consult and the tenant may wish to employ the hotel manager or chef elsewhere. Also consideration should be given to any pension scheme.

### **NAME AND GOODWILL**

The name of the hotel may already belong to the landlord and the tenant may merely be permitted to use it under the lease. The name, however, may belong to a third party (for instance one of the big hotel operators) under a franchise agreement. Can arrangements be made now to enable the landlord to take over that franchise agreement in the future? Although this may be difficult, the lease should at least oblige the tenant to introduce the landlord to the franchisor at that stage to enable negotiations. The tenant should also be obliged, in so far as he/she owns it, to transfer the goodwill to the hotel at the end of the term.

### **WET AND DRY STOCKS AND FF&E**

With the possible exception of some items of FF&E (which may be owned by third-party lessors or by the landlord), these items are likely to be owned by the tenant and provision should be made for a stock-take and valuation on the handover of the business.

### **BOOKINGS**

There may be forward bookings under which deposits have been charged and there will almost certainly be bookings that straddle the handover of the business. The lease should provide for appropriate payment adjustments and debt collection arrangements between the landlord and the tenant.

## **CapEX AND FF&E FUNDS**

The lease may provide for the creation of CapEx and/or FF&E funds against future expenditure. The lease should state what is to happen to these funds on the handover of the business and whether they will pass to the landlord or be wholly or partially refunded to the tenant.

## **TAXATION**

The transfer of the business is likely to be an ongoing concern transfer for VAT purposes but the landlord will need to register for VAT purposes. The lease should state VAT requirements and deal with all other taxes relevant to a hotel operation such as PAYE. The lease should also deal with the apportionment of any ongoing capital allowances.

## **OPERATING REQUIREMENTS**

These will be important for the future operation of the hotel business and will include VAT, employment, booking, and hotel guest information. The lease should provide that this is made available to the landlord upon the termination of the lease. Where the information is stored on computers in the hotel, rather than off-site, the computers and all back-up records should be handed over to the landlord on transfer of the business.

The lease should also deal with the safeguarding of hotel and drinks licences, insurance arrangements, and third-party agreements.

## **TENANT'S IMPROVEMENTS**

In certain circumstances, a tenant who carries out improvements to the building may be entitled to compensation from the landlord at the end of the term. Most hotel leases provide for constant improvement by the tenant to maintain standards and this is taken into account in the overall financial terms. It might therefore be unfair for the tenant to be compensated for such improvements. The lease should exclude the tenant's compensation rights so far as the law allows.

## **CONCLUSION**

Considering all these arrangements at the start, rather than at the end, of the lease may seem to create extra initial work. But it will be time well spent when the lease comes to an end and the parties have a clear understanding of the hand-over arrangements between them.