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5 Considerations For Foreign Buyers Of US Hotels

By **Andrew McIntyre**

Law360, Los Angeles (June 03, 2015, 3:37 PM ET) -- While foreign investors continue to pump billions of dollars into U.S. hotels — South Korea's Lotte Group recently purchased the New York Palace Hotel for $805 million — such deals can be particularly tricky for buyers who don't have much experience in the U.S. real estate market, lawyers say.

As more foreign first-time buyers and non-real estate firms jump into U.S. real estate, hotel deals in particular pose a variety of challenges.

Hotel buys are complicated real estate deals even for seasoned U.S. investors, in part because hotels are ostensibly operating businesses. Attorneys say foreign investors with little experience in U.S. real estate need to pay careful attention to the source and structure of financing, hotel management agreements, tax structure, and due diligence.

Here, Law360 looks at the issues foreign buyers of U.S. hotels need to keep in mind:

Financing

Lawyers say how financing is structured, who the lenders are and where they are located are crucial considerations for foreign investors looking to do U.S. hotel deals.

During the Japanese investment boom of the late '80s and early '90s, many Japanese banks came to the U.S. to help Japanese companies finance deals, and to some extent that is happening now with Chinese banks and Chinese companies, said Hushmand Sohaili of Akin Gump Strauss Hauer & Feld LLP.

But while foreign buyers may prefer to obtain financing from a bank in their home country, the massive size of such deals, many of which top $1 billion, often requires companies to look for financing from U.S. banks as well and to use more complex financing than they would on smaller deals.

If, say, commercial mortgage-backed securities financing is involved, that creates even more complications, said Stephen A. Cowan of DLA Piper.

“The organization structure is a challenge. The CMBS lender needs to know how it's organized all the way up through the foreign entities," Cowan said. “Financing is much more complex. Hotels are just a very different kind of property. They are triply complex.”

Hotel Management

Hotels deals come with the added question of who is going to manage the hotel, and lawyers say foreign investors either have to bring their own knowledge and resources to the table or team up with a company that will be able to run the property effectively.

“Especially if it’s a luxury hotel. How do you manage it?” said Sohaili. “Do you have resources in place to be able to effectively do that in a foreign country?”

As a result, such deals usually involve third parties, according to Cowan. The list of third parties involved in such deals could include food and beverage vendors and even credit card companies, lawyers say.

“Unless your sponsor is also a manger and/or a brand, then you’re also talking about third-party hotel managers,” said Lawrence C. Eppley of Sheppard Mullin Richter & Hampton LLP. “The sponsors have acumen and the experience and expertise to get the project done."

Tax

A key consideration for foreign purchasers of U.S. hotels is what the tax implications will be when the property is sold, said Sohaili: “That’s going to be the first on the list."

Such dispositions are subject to tax under the Foreign Investment in Real Property Tax Act, although deals can be structured to avoid it, since the tax can be refunded if the seller has fulfilled its other U.S. tax liabilities.

Those other tax liabilities will vary based on how the acquisition is structured. Location of the investor, what type of company is making the investment and the goals of the investor play a role in determining the structure.

Foreign buyers, for example, can buy a property directly, can buy the property via a U.S. REIT or can buy the property through an LLC.

If real estate investment trusts are involved, that adds yet another layer of tax complexity. REITs cannot operate hotels, since they by definition aren’t allowed to operate businesses. Therefore, when investors are using REITs, they must be certain they structure the deals so that the REIT doesn’t lose its REIT status.

Operating Business

Hotels are more complex because they are businesses in addition to real property. For that reason, a foreign buyer — particularly one doing its first large real estate deal in the U.S. — needs wide-ranging counsel on the ins and outs of not only real estate acquisition but also business acquisition.

“The hotel is a more complex investment because it’s an operating business,” said Audrey L. Sokoloff of Skadden Arps Slate Meagher & Flom LLP. “Instead of looking at the income stream and expenses, you really need to understand the hotel operations."

Foreign buyers need to realize that although hotels can generate the returns they are looking for, the deals are more complex than office property acquisitions, lawyers say.

“To buy a one-off hotel and to think that you will have the people in place to be able to really deal with it — that’s pretty challenging,” Sohaili said. “Because it’s such an active operational asset.”

Due Diligence

Due diligence is always time-consuming and tricky for foreign buyers of real estate, but it can be even tricker when hotels are involved because there are typically more moving pieces and parties involved. For first-time buyers, the due diligence phase can be a major challenge.

“This is a new market to some of these clients,” said George Wilson, managing director of IVI Assessment Services, a CBRE Inc. company. “They are looking at getting familiar with the process of due diligence here in the U.S.”

Lawyers say the time frames for conducting due diligence have become shorter and that makes the work more difficult, particularly when it's being done from halfway around the globe.

Foreign buyers need to get up to speed quickly on environmental and energy efficiency aspects of such properties, for instance, said Simon T. Adams of Reed Smith LLP.

“It’s all about the team,” Adams said.

--Editing by Kat Laskowski and Kelly Duncan.
