The rise of lessor non-disturbance agreements in hotel ownership structures in Dubai

Real Estate Update

16 SEP 2015

By:

With some of the highest RevPAR (revenue per available room) figures and occupancy rates in the world, Dubai continues to be an attractive location for hotel developers. The rapid pace at which the market is evolving however and the nature of the hotel ownership structures in place, have given rise to several issues that developers and other sector participants need to be aware of when seeking to establish or operate in the region.

In this article we explore the rise of the Lessor's Non-Disturbance Agreements (Lessor NDA). To set the scene however, we first take a look at the hotel ownership structures that give rise to these.

A quick lesson in hotel ownership structures in Dubai - PropCos and OpCos

Due to local laws and regulations, there is an increasing trend for hotel developers to establish "PropCo/OpCo" structures. Under these structures, the property holding company (PropCo) acquires the site and enters into a hotel management agreement (HMA) with a hotel operator, later granting a long lease of the hotel to the operating company (OpCo) in order to comply with local laws and regulations, in particular relating to obtaining and maintaining the necessary permits.

Land ownership by persons who are not nationals of a Gulf Cooperation Council state (non-GCC nationals), or companies with some or all of its shares being held by a non-GCC national are, is restricted to certain areas of Dubai referred to as ‘designated areas’. Within designated areas, the only type of off-shore company that can be registered as the owner of real estate is a Jebel Ali Free Zone (JAFZ) offshore company. Using a JAFZ offshore company permits 100% of the shares to be held by non-GCC nationals. It is also relatively simple to incorporate with relatively low maintenance costs, making it a popular vehicle for site acquisitions. Developers therefore frequently opt for a JAFZ Offshore Company to hold the title to the site.

However, a JAFZ offshore company cannot obtain the necessary permits for operating hotels in Dubai (for example, the hotel operating permit from the Dubai Tourism and Marketing Commerce, a permit to sell liquor from the police department or a visa for the employment of hotel staff) and therefore a local OpCo must also be established, usually a local limited liability company.

Issues arising from PropCo’s grant of a lease to the OpCo

The PrOpCo commonly grants a long lease of the hotel to the OpCo, usually when construction is almost completed and operating permits etc, can be applied for. Upon such a lease being granted, the PropCo then novates its rights and obligations under the HMA to the OpCo. Operators need to ensure that they are happy with the terms of the proposed lease to OpCo prior to giving their consent to novating the HMA to OpCo. Of the utmost importance is that the proposed lease is for a sufficient duration to cover the operating term and any renewals.

In Dubai, the grant of the lease gives rise to an additional consideration as leases with a term of 10 years or greater need to be registered at Dubai Land Department, for which a fee of 4% of the ”total value of the rent contract” will be payable. Although registration is mandatory, having to pay a potentially considerable fee does often cause a developer to either not register the lease or to insist on granting a lease of less than 10 years which can then be renewed. In the case of non-registration, a strict reading of the applicable law renders the lease void and it is not yet clear whether a lease of less than 10 years which has automatic renewals would be treated as being for a term greater than 10 years and therefore subject to registration at the Dubai Land Department.

Therefore, the use of a PropCo/OpCo structure leaves the operator with an ”owner”, under the HMA, which has a leasehold interest, which may be vulnerable to termination or being declared void, and which (as a special purpose vehicle) does not own any assets.

Enter the Lessor NDA

In the scenario outlined above, international hotel operators frequent require the parties (PropCo and OpCo) to enter into a Lessor NDA directly with the operator. A Lessor NDA requires the PrOpCo to essentially “step-into” the HMA if ever the long lease to the OpCo is terminated, declared void etc.

The terms of the Lessor’s NDA should include: (a) a direct covenant from the PropCo to the operator not to terminate the lease during the operating term under the HMA, and (b) if the Lease is terminated, declared void or otherwise comes to an end before the expiry of the operating term under the HMA, the PropCo agrees to take a novation of the HMA.

Lessor's NDAs provide operators with comfort that the HMA will run for its full term notwithstanding the leasehold structure put in place by the PropCo. However, although this offers the operator contractual protection, it is important to bear in mind that if the PropCo ever refuses to take a novation of the HMA in circumstances which, pursuant to the terms of the Lessor’s NDA, it is required to, the operator would not be able to obtain an order for specific performance from the local courts as this is an equitable remedy which is not available under the civil law system of the United Arab Emirates. This equally applies to injunctive relief, meaning that an operator will not be able to apply for an injunction to prevent the PropCo from terminating the lease.

Therefore, the only remedy for a breach of the Lessor’s NDA would be damages. The value of the Lessor’s NDA arises from the lessor providing the operator with direct contractual obligations from the PropCo, rather than the OpCo which is unlikely to hold any assets. This allows the operator to pursue the PropCo (which owns the hotel and will hold bank accounts) for damages.

Return to Real Estate Gazette Issue 21