# Briefs and bedrooms:

## The best of CMS Cameron McKenna in Hotel Report

C/M/S/ Hotelreport

# “Best of the Best”

The hotel industry is a key factor in the world economy, both as a gateway into emerging and developed markets and as one of the largest employers of the world. The legal issues the industry faces day to day cover the full spectrum from real estate and intellectual property to employment and contract law.

The CMS hotel practice operates a significant group across Europe and into Asia. The team understands the industry and advises clients –whether investors or operators, banks or occupiers – with the many legal issues they face on a daily basis.

As part of our practice CMS volunteered some years ago to write monthly articles on hotel related issues for Hotel Report. We are delighted to do this as the issues we can cover may be topical, unusual or novel but always interesting. In our article on Ukraine and European Cup 2012, we discuss the explosion of interest in the Ukraine and the speed at which shopping centres and office towers are being built but the apparent lack of hotel accommodation to satisfy demand. Another article discusses the increased appeal of destination and residents clubs throughout Europe and how their influence is changing the range of hotel accommodation available. Finally, an article on bed bugs will get you itching to read more. Each article gives only a summary of some of the key issues; it is not intended to be a comprehensive guide or to provide specific advice.

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## About CMS Cameron McKenna

CMS Cameron McKenna has a substantial European network across 24 countries, which means you get consistent high-quality advice in all the European countries in which you do business.

Using a law firm that understands your business and your industry means you get better, more relevant, advice more efficiently. Our hotel group has an unrivalled profile and we are recognised as number 1 UK law firm for the hotel industry by The Legal 500 directory. We are acknowledged experts in the hotel industry and advise on every aspect of the industry, including management and lease agreements, acquisitions and disposals, construction, financing and operational issues, often with a cross-border element.

“The cross-departmental hotels team receives consistent praise from clients” The Legal 500

## About Hotel Report

Hotel Report is the leading provider of news to the senior players in the hotel sector. We provide a breaking news service online and in-depth market commentary through the monthly newsletter, which features contributions from established sector experts, top ranking executives and correspondents across the globe.

Hotel Report is published by William Reed Business Media,
Broadfield Park, Crawley, West Sussex, RH11 9RT



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BUSINESS MEDIA

# Residence clubs

Have you dreamt of spending your hard-earned retirement jetting between properties in the hip cities of Paris and Milan, the golf courses of Florida and the Algarve and the beaches of the Riviera and the Caribbean? For most of us it remains just that, a dream.

However, dreams can occasionally come true. There is a growing market for the destination or residence club, a hospitality product that is becoming widely available on the market at relatively affordable prices. Members are attracted to these clubs, because instead of spending their life savings buying their own villa in Spain, they are able to spend a similar amount buying a share in a number of holiday properties around the world.

## Fractional ownership

This trend is part of the growing concept of "fractional ownership" that is now being applied to leisure properties, supercars, yachts and executive jets. London recently saw its first trade show dedicated to the fractional ownership market. This market is creating an affordable way of accessing a lifestyle that would otherwise be out of reach.

## Destination and Residence Clubs

Destination clubs and residence clubs have been a long-standing feature in the US hospitality industry. They are now beginning to become more common in the UK and Europe. Fractional ownership schemes in Europe have been tainted by timeshare scandals at the low end of the market. But the new generation of residence and destination clubs are a large step up from timeshare. These clubs are often run by highly reputable hotel companies, who are leveraging their knowledge and expertise in hospitality to exploit the fast-growing fractional ownership market.

The term "residence club" often refers to members' shared ownership in just one property or unit within a larger property. An example in London is Marriott's 47 Park Street. A "destination club" (or "vacation club" as they are often known as in the United States) is a club that owns a number of different properties in different locations.

But the terms "destination club", "residence club" and "vacation club" are often used interchangeably and the products available do not always neatly sit in one definition or the other. At 47 Park Street, you can trade your usage rights for stays at other Marriott Vacation Club properties around the world.

**This market is creating an affordable way of accessing a lifestyle that would otherwise be out of reach for many customers**

**An equity destination club allows the member to share in any capital appreciation of the properties in the club**

## Club membership rights and costs

To join a destination club, a member pays a lump sum deposit and usually a smaller annual service charge. Some of the deposit is returned when the member leaves or sells their membership. Membership buys the right to use a number of residential properties owned by the club.

These are often apartments or villas in holiday, golf or ski resorts. The member is entitled to a fixed number of weeks or points per year that can be exchanged for stays at club properties of their choice.

The majority of the clubs on the market at the moment require initial deposits of around £100,000 to £300,000 and annual service charges of around £5,000 to £15,000. These are firmly in range of anyone who might otherwise have considered purchasing a second home. Some at the very top of the market will cost millions to join for extended use of some of the very best properties money can buy.

## Equity clubs

Equity destination clubs are less common. These are clubs where the member actually acquires an equity interest in the club and hence a share in the underlying values of the properties. Unlike other destination clubs, an equity destination club allows the member to share in any capital appreciation of the properties within the club. This is on top of the rights to use the properties throughout the period of membership. They are often marketed as investments with extra benefits of usage, rather than simply as a leisure product.

## Club structures

Non-equity clubs can simply be a form of contractual relationship between the members and the club operator and property owner and as a result, their structures are both more flexible and more simple.

Equity clubs are more complicated due to the need to vest a share of ownership of the real estate in each member and also the fact that the marketing of memberships as investments are often strictly regulated by financial services laws in the jurisdictions in which the club and its members are located.

Equity clubs consist of a corporate or partnership vehicle in which members acquire shares or a partnership interest. The properties may be held by that vehicle, but for tax reasons (and especially if the club's properties are spread across several jurisdictions) the properties are more likely to be held by separate corporate vehicles owned by the club holding vehicle. The club will then enter into a management agreement with the manager who will maintain the properties on behalf of the club and operate the reservations system that allocates time to members based on their requirements and their usage rights.

Knowledge of international tax treaties is vital

The home jurisdiction of the club will depend not only upon where the properties are located but also the target market for members. For example, if all members were to be recruited from the United Arab Emirates, then for tax and securities laws reasons, you would choose a different jurisdiction than if you were marketing the same club to UK and Irish members. Detailed knowledge of international tax treaties is vital to find the most efficient tax structure for members and the property holding companies.

## Reservations systems

One of the biggest challenges for clubs has actually been the reservations policy. Some clubs operate a first-come, first-serve basis, but popular weeks or properties use up more points to even out demand. Other clubs have a rotating priority system where all requests from members are collected and allocated according to a strict rotation. Coming up with a system that will give all members fair access to all the properties, whilst still retaining the flexibility demanded by people who are used to getting what they want, can be the most difficult part of setting up such a club.

*Tom Page*
*Hotel Partner, Corporate, London*

*October 2007*

# IP Healthcheck

Building a competitive edge in the hotel industry requires innovation, development, investment and planning. A key aspect of any successful business in the sector will be the maintenance of the intangible assets in the intellectual property portfolio. A healthy portfolio will differentiate between operators and act as a vehicle for commercial goodwill, as well as providing a strategic and defensive base from which to operate.

Every business should conduct an Intellectual Property audit and revisit it periodically. The importance of the role played by IP in the modern hotels sector is indisputable.

Understanding the strengths and weaknesses of your portfolio, and the value of the assets both internally and externally, is a fundamental part of business planning. This is an approach that should be followed in the boardroom, as well as at the "coalface", so the IP is used for maximum effect in the market. Perhaps the IP portfolio is registered, renewed and up to date, but is this reflected in the latest management agreement, brand manual or franchise agreement?

In the past, IP audits have been seen as defensive measures to identify assets risks in current procedures and practices. However, a good IP audit tailored to your business may also discover hidden treasures – intellectual assets that are ripe for protection or commercialisation to add value to the company.

Waiting until a problem arises with your IP before any positive action is taken is waiting too long and your competitors may not make the same mistake. This may mean confronting tensions and difficult issues up front, such as the allocation of goodwill between owners and operators, rather than waiting until it becomes an issue.

### The IP audit

The practicalities of working with businesses on an audit of their IP portfolio requires a specialised approach, and the relative importance that IP rights such as patents, trade secrets, trade marks, domain names, copyrights, designs, get-up and trade dress play can vary enormously between industries.

For service industries such as hotels, understanding the importance not only of the IP, but the competitive environment in which it operates, is paramount.

As operators move away from bricks and mortar towards a franchise and management agreement model, the IP rights must act as bridge between the bricks and the brand.

Brand leverage from established players in other sectors is also an important development for the industry, with a number of luxury and lifestyle brands seeking to enter this space to take advantage of the perceptions of their products and services generated elsewhere.

**If there is no business case for the maintenance of an asset it should be deployed elsewhere, sold or abandoned**

### Identifying issues, and also opportunities

The IP audit is about much more than looking for areas of weakness or disputes. It is structured to go beyond the obvious and to look at the commercial reality of the assets and their scheme of protection (or lack of).

The benefit is unearthing assets that can realise value – either in building the business for the future or, where they are not core, as saleable assets that can raise revenue to be used to invest in the core business of the organisation. As such, the process has the dual benefit of reducing risk, as well as a means to obtain competitive advantage.

Taking the complexity out of your IP helps it to tie in to the business plan to promote, protect and add value. Many companies waste money when the proper protection of intellectual assets is actually a business investment – and one that can be a springboard to business success.

Every penny spent on IP protection and enforcement must work hard to justify itself. If there is no business case for the maintenance of an individual asset in its current role, it should be deployed elsewhere, sold, or abandoned.

### Some common questions

Each audit varies greatly according to the composition of the business (and whether it has grown organically or been acquisitive), its geographical focus, and its business model (owner, operator, franchisee etc.). However, common issues on the review will include:

- **IP registration:** A critical review of the IP registration policy for core business, and the stage at which registration is considered. Never too early, but often too late?
- **Portfolio management:** Consideration of the structure for licensing of core assets and arrangements for dealing with renewals and maintenance. A review of record keeping and investigation of compliance by licensees. The Madrid system in particular is a good cost saving tool.
- **Ownership and subsistence:** A review of contractual entitlement and other arrangements for the ownership of IP, particularly in relation to third party contractors, and a critique of the evidence of creation and subsistence. Waiting until you have a dispute is rarely a good time to start looking.
- **Infringement and disputes:** Considering the key drivers in enforcement policy, the most efficient method of protecting assets, as well as identifying perceived areas of weakness.
- **Licensing and commercialisation:** The final stage of the audit, assisting the business to identify opportunity and utilise the IP for strategic and financial gain. Healthy IP can reduce borrowing risk, increase market value, and help attract investment.


A well-timed review can find undetected problems

**A good IP audit may discover intellectual assets that are ripe for protection or commercialisation**

### A worthwhile investment

A well-timed strategic review of the business can provide a cost effective solution to undetected problems, as well as a competitive advantage in the battle for business. The earlier a company focuses on getting its processes and policies properly organised, the better.

This saves valuable management time and heads off the risk of costly disputes later. Once a good audit has been conducted it will be cost effective to revisit this periodically and can not only save significant sums but also generate revenue both in the short and long term. Wise organisations value such investment.

*Isabel Davies*
*Partner, Intellectual Property, London*

*Tom Scourfield*
*Associate, Intellectual Property, London*

*April 2007*

# Retaining staff for 2012

Concern about staffing in the run up to the 2012 London Olympic Games is beginning to mount in the hospitality sector.

The retention of skilled staff is already becoming an issue as staff are being poached to secure a first class service to clients at the Games. Retention has not traditionally been an issue in this sector, which is used to casual staff, at least in the lower paid more menial jobs.

However, employers must now work harder at retaining all staff, not just those in key posts, by making their jobs attractive for long-term staff. With shift from "hire and fire" to staff retention, employers will have to focus on improving employees' satisfaction with their job.

Good treatment of staff therefore becomes more important, and focus may shift from compliance with say minimum wage and working time laws, to provide a cost effective package of good working environment and incentives/benefits for staff. Unfair dismissal, only available to employees with a year or more of continuous service, may be more of a concern.

Methods of retention should be both stick and carrot approach. The stick would be trying to make the decision to leave more difficult or more financially painful for employees.

The carrot is of course rewarding employees who do stay with you. Sometimes these two aims can be achieved by the same tool, for example some form of profit sharing scheme which only pays out to those in service at the year-end and on the delayed payment date. Other times one tool may be the stick and a different one provide the complementary carrot, and employee acceptance is gained by packaging the two together so one cannot be accepted without the other.

**Subtle incentives such as additional training can be effective in retaining key staff and improves the quality of the service**

Longer notice periods are often imposed on key staff to make sure that they cannot leave quickly, and therefore reduce their mobility. However it is difficult to extend notice periods once they have been agreed, as unilateral changes to contractual terms and conditions of employment are ineffective.

It is also difficult to enforce notice periods as once an individual has left a job the courts will not force them to return to their old job. Damages for breach of contract is the only realistic remedy but suing for damages in such a case is rarely worth an employer's time and money. However, the deterrent effect of a longer notice period from employees can still be worth having, as many employees and potential employers can be deterred by the risk of being sued.

Restrictive covenants, which come into effect once an employee leaves, are another potential tool. The relevant restraint would be a non-compete clause, which aims to prevent an employee from setting up in competition or going to work for a competitor for a specified period of time. But to be legally enforceable, the employer must be able to prove he needs the clause to protect his confidential information or from the ex-employee poaching his clientele. So while these can be effective for key workers, say a hotel general manager or an executive chef, they simply will not work with less exalted members of staff where those concerns will not generally be provable.

Such restrictions must be carefully drafted to ensure that they are not void as in restraint of trade and go no further than is necessary to protect the employer's legitimate business interests. And, of course, they have to be written down and signed by the employee and the best time to get the employee to agree is when they are joining or being promoted.

Incentive schemes, such as all employee share save schemes, popular in the supermarket sector, have been proved to help maintain a positive attitude and enhance staff retention. Leavers have something to lose if the schemes are well drafted.

Share based schemes will hardly be practicable unless the shares are quoted on a recognised stock exchange. While it is possible to operate schemes over shares listed on a foreign exchange, there are a lot of complications if the shares are not listed on the London Stock Exchange or Aim. Private companies or smaller listed companies may find that selective, rather than all-employees, share schemes are the answer for targeting key staff without too much bureaucracy.

Simple schemes, such as cash reward schemes giving the employee a bonus on the anniversary of his joining, might be easier to administer and be even more effective. An annual pay increase linked to the employee's length of service has also been a popular retention tool in the past and is set to continue to be so despite qualms when Age Discrimination laws were first mooted which suggested that benefits based on length of service would be unlawful.

However, under the 2006 Employment Equality (Age) Regulations, there is a specific exception for the provision of benefits linked to length of service provided the period is five years or less.

There is also a general exception for provisions based on more than five years service if the underlying reason for the provision fulfils a business need of the undertaking, which in this case would be encouraging loyalty.

**Employers will need to ensure that the culture and climate at work means that people want to work there**

Employer pension contributions is a tax efficient ways of giving staff benefits and are traditional retention tools – for example offering employees a % contribution into a pension scheme after a certain period of service.

They are cheaper than cash pay rises for employers as an equivalent % pay rise means that the employer also has to pay additional national insurance contributions based on that amount, while the employee receives less than the full % because income tax is payable on it. Stakeholder pension plans can be the vehicle for this without involving the employer in much administrative hassle or financial headaches.

Subtle incentives such as additional training can also be effective in retaining key staff. This not only improves the quality of the service provided but also demonstrates that the employer is willing to invest in the employee and increase his skills set. Allowing creative ways of working have also proved valuable and flexible working policies, which allow employees to work non-typical hours, are a proven method of retaining staff.

However perhaps the most obvious way of retaining staff is the most effective of all. Employers need to ensure that the culture and climate at work means that people want to work there. Brand image is important and being a recognised employer of choice with a good reputation can help in retaining, and recruiting, staff.

Other ways of showing employees that they are valued include ensuring that health and safety is respected and that equal treatment of all staff is expected.

Equal opportunities policies should be circulated and implemented so that there is a climate of non-discrimination and that employees feel that any discriminatory treatment or harassment at work will be properly dealt with.

Wages are also key. Payment of the minimum wage may be lawful but inevitably means that employees will look around for other better paid work. Staff should be paid properly at or above the prevailing market rate. Nothing beats a nice place to work, where you are treated and paid well.

*Simon Jeffreys*
*Partner, Employment, London*

*November 2007*

# Asset-Light – managing or leasing?

The factors that hotel operators consider when shifting their real estate off their balance sheets. The last six years has seen a growing trend for operators to seek to dispose of their real estate assets whilst keeping the hotels within the operator's stable of brands, driven by a number of factors:

- Recognition of hotels as an asset class for property investors.
- Increasingly high prices paid due to both cheap debt and a large surplus of demand over supply for more traditional commercial property investments.
- Shareholder demands for owner/operators (especially listed companies such as InterContinental, Hilton and Accor) to release capital from their balance sheets to return to shareholders and improve return on capital employed.

Sale-and-leasebacks have long been used as a way to release value from a real estate investment and hotel companies are certainly not the only sector where this is common.

Such transactions are often used for pubs, retail premises and non-real estate assets such as ships, aircraft and even films.

Sale-and-managebacks have only really become common in the last few years as part of the disposal programs of the big owner/operator chains that have been moving towards their "asset-light" strategies of becoming hotel management companies rather than owners of real estate.

### Why a management agreement not a lease?

One of the main advantages of a sale and manageback for an operator selling hotels is the reduced risk. The management agreement reduces their exposure to the fluctuations in profitability of the underlying business.

Under a lease structure, the operator has all the operational business risk and the obligation to pay the rent.

A seller of a portfolio is in a good position to dictate the basic terms of the management agreement such as term, fees and performance testing.

This gives operators a long-term secure income stream. A management agreement, with that associated income stream, is an asset, whereas a lease, with its obligation to pay rent, is a liability.

This has an effect on the way investors value the operators' shares.

There can also be some tax and accounting advantages.

For these reasons, it appeared for a while that sale and lease-backs were going out of favour. The high profile case of Le Méridien might well have accelerated that view.

Shortly after a sale-and-leaseback to The Royal Bank of Scotland, Le Méridien's business suffered from the effects of an economic downturn, 9/11 and SARS.

If profitability drops, rent payments may suffer

## Swallow Hotels' collapse has highlighted the risk of a badly structured sale-and-leaseback strategy

It could not meet its rent payments on, amongst others, The Grosvenor House and The Waldorf hotels, and RBS took back the leases.

More recently the Swallow Hotels collapse has highlighted the risk of a badly structured sale-and-leaseback strategy. In that case, at risk of slightly over-simplifying the facts, Swallow bought the hotels, put in place high rent leases and then used the rental yield to sell the hotels again at ever-higher prices.

This worked as long as the continuing profits on sale exceeded the losses caused by the shortfall of gross operational profit needed to pay the rents.

### Leaseback come-back?

Although the advantages of a management agreement seem to be clear, a number of operators still favour a leaseback model. And it does still have its advantages, especially if it is structured to avoid the risks.

The biggest risk is that if profitability drops, the operator will not be able to meet the rent payments. There are two ways in which this risk can be mitigated or avoided:

- Set rents at a manageable rate.
- Use turnover rents that reduce if business drops, with or without a minimum base rent.

These would seem obvious, but in some cases can be difficult to implement.

For an operator that is already highly geared, it may need to raise a fixed amount of capital from the sale. If it sets the rent lower, it will not achieve the required sale price.

Setting a variable rent requires the purchaser landlord to assume some exposure to the operational business risk.

Ironically, it is the very success of sale-and-managebacks that has made hotel real estate investors more comfortable with assuming a certain level of business risk.

The other advantages of a lease arrangement are that the operator retains all the benefit of the operational turnover and profit, rather than just taking a small percentage of both. It can also be easier to market and sell.

There are more investors willing to buy real estate with a rental yield than there are investors willing to assume the complete business risk of a hotel's operations.

Finally, a lease gives an operator much more control and freedom to run the operations as it thinks fit. Not so with a management agreement.

### Convergence?

A number of operators looking for disposals still favour the sale and lease-back model. Accor recently sold large portfolios across the UK, Germany and the Netherlands.

In recent months, MacDonald Hotels and Permira's Principal Hotels Group have both marketed portfolios on a sale-and-leaseback basis.

Menzies Hotels was looking at a sale-and-leaseback before its owners decided instead to sell the whole group.

In some ways the two models are converging. A turnover rent lease places some of the business risk onto the landlord; more so if there is no minimum base rent.

Management agreements have been seen with guaranteed or priority owner's return taking some of the risk away from the owner.

It is becoming more common in both models to see both the owner and the operator sharing the operational risk – the only significant difference being the balance of that risk.

*Tom Page*
*Hotel Partner, Corporate, London*

*December 2006*

# Condo Hotels

A panel session for Condo Hotels at 2006 Berlin International Hotel Investment Forum billed the subject matter as the "red hot sector".

The heightened interest springs from the continuing success and expansion of schemes in the United States (forecasts suggested over 4,800 new units would open in 2006) and that in the UK and the rest of Europe this is an area which is still very much in its relative infancy.

From a private individual's perspective, Condo Hotels provide an affordable alternative to the outright ownership of holiday homes and a means of investing in real estate outside the stock exchange.

You need only to flick through the supplements in your weekend paper or to watch one of the many television programmes dedicated to the subject to see the considerable appetite in the UK for buying second holiday homes.

Here is the opportunity to buy not just a holiday home in the likes of Aspen or Miami Beach, but one with the full range of amenities and the possibility of a variety of other benefits (depending on the operator and the scheme).

There is the logical appeal of paying for what you use: why pay full market value for a property that you use for only a fraction of a year?

There are many other attractions: do away with the administrative hassle of maintaining, managing and marketing your property, and the prestige of an association with a leading sector brand in the best locations

There is genuine optimism that a separate resale market will develop in due course, although the fractional market particularly for membership clubs, often restricts selling-on.

## How does it work?

In simple terms, this is a sale and manage-back to each private investor. The investor is sold a property interest comprising a single hotel room or, in larger factional schemes a holiday apartment or villa.

In the UK, the property investment asset would


James Miller: the resale market is underdeveloped

**There is no reason for the lease not to be on the same terms as you would expect for an outright ownership property**

typically be a long lease. There is no reason for the lease not to be on the same sort of terms which you would expect to see for an outright ownership property and acceptable to a lender, except that the condo hotels lease would seek to remove outright entitlement for the investor to occupy the room. The sophistication lies in the manage-back. In addition to the usual manager's obligations, a Condo Hotel Management Agreement will cater for a host of administrative services to be undertaken for the investor's benefit; general and more specifically VAT accounting; VAT; management and other tax management for instance for foreign investors.

Typically the investor receives as his Owner's Return a percentage of the gross receipts attributable to his hotel room (i.e., receipts for food, beverages, car parking etc are excluded), after deduction of the manager's fees and service charges for ongoing maintenance and repair of the hotel.

In some products marketed, the Owner's Return is guaranteed and perhaps also the service charge deductions are capped for an initial fixed period. In more sophisticated models the Owner's Return (or maybe in part) is taken into account in the success of the hotel or wider scheme as a whole. The Condo Hotel Management Agreement should give the investor the right to use his hotel room for a minimum number of days in each year.

Typically the investor's entitlement is worked out on a points system, allocating a different number of points to individual days of the week and different times of the year. Under some agreements these points may be used at different hotels run by the same operator; or in some other way may entitle the investor to preferential treatment at other hotels/resorts run by the same brand/membership club.

## Buyer beware

On a cautionary note, there are some drawbacks. These are long-term investments. The sweetener of the guaranteed income return seems, in relative terms, short-lived.

After that, the Owner's Return is dependent on general and local market conditions as well as the manager maintaining performance standards. For these products there seems to be an overwhelming reluctance on the part of the operator to commit itself to specific performance targets/operational standards or a proper company guarantee.

This may be the state of the market but the finer detail of these products seems to be dictated by the manager's own terms. Should market conditions for the sector change for the worse, these terms could be perceived to be unfair, which could open the possibility of specific regulation.

This happened in the past with timeshare selling. As already pointed out, the resale market is currently undeveloped and its potential is today largely an unknown, although that could change in the future.

*James Miller*
*Hotel Partner, Real Estate, London*

June 2006

GuestInvest: the latest UK condo hotel offering

# Investment in CEE 15 years on

When, in the early nineties, the CEE real estate and hotel markets opened up, the Czech Republic, Hungary and Poland attracted the vast majority of inward investments. Early arrivals made very attractive returns as a result of low operating costs coupled with high room rates driven by a shortage of high-end accommodation in these destinations. Today these markets still generate strong interest, though with the many hotel developers, investors and operators now competing for a decreasing number of opportunities. A second wave saw investors turn their sights further east, towards Croatia but also Slovakia, Romania, and Bulgaria. Most recently investors have started to look seriously at Ukraine and, of course, Russia, attracted by the size of the potential markets and rising domestic incomes, though wary of political considerations which can complicate the picture.

**So what does the CEE investment environment look like today?** Today all the well-known hotel operators and real estate agents are present in the region. These global investors and operators have brought with them their construction standards, their sophisticated project management procedures and operating documentation as well as their advanced portfolio management systems, and these have thus gradually become an established part of local procedures and documentation. The financing institutions have followed these investors and operators, with the Austrian and German banks leading the way and today representing the biggest regional lenders. Newcomers to the scene in the recently newly acceded EU countries will therefore see a very comparable situation to the "old" European countries.

**And how about the legal framework?** Whilst most of the CEE countries have by now developed an acceptable legal framework within which both the real estate and operational side of the hotel business can function, each country still has its own particularities which means that the ease of doing business and the kinds of issues faced still vary country by country. The legal systems of the original new EU entrants have been strengthened by the alignment with the EU legislation, while Bulgaria and Romania were still making changes prior to their 2007 EU accession. Generally, the legal environment of Ukraine and Russia is less reliable and predictable, which in turn can bring higher execution risk, and greater concerns about successful enforcement of any contractual rights which

**Global operators have brought in management procedures, portfolio management systems and building standards**

Competiton is increasing as opportunities decline

may impact on availability of suitable financing.

There is one feature though that an investor should be prepared for regardless of where in the region it operates and that is the highly bureaucratic nature of many of the procedures required to develop, operate or invest in a hotel venture. Involvement in the acquisition or the development aspect of the business will require dealing with local land and title registries which can be an highly frustrating experience. The registration of a transfer or a pledge of property is often only completed months after the execution of the contract and often only after a substantial part, if not all, of the funds have changed hands. In the worst case scenario the registration can be refused without any justifiable basis or for a minor formal administrative error. When that happens, experience shows that walking to the Land Registry with a box of chocolates and a bunch of flowers can often be more effective in resolving the dispute than wasting years in court suing to get your right.

To give a flavour of the mix of the issues you may be faced with, here are some more recent developments in individual countries.

**Czech Republic** – Employment regulation: Hotel managers need to take care when structuring outsourcing contracts as there is a general prohibition on hiring self-employed subcontractors in situations where these can be employed as regular employees. Compliance with this rule has recently been subject to control by tax authorities who

**Walking to the Land Registry with chocolates and a bunch of flowers is often more effective than wasting years in court**

have imposed tough penalties on transgressions by employers.

**Hungary** – Improvements to Zoning: On 1 May 2006 an important amendment to the building code came into force. Developers can now enter into an agreement with the competent local municipality aimed at accelerating the change of zoning of a particular development site, by agreeing to undertake some of the associated obligations of the municipality.

**Poland** – Zoning delays: From a hotel investor's perspective, one of the biggest issues in Poland currently relates to the development phase and the risks associated with acquiring land without zoning.

The new zoning law brought into force in 2003 caused a significant proportion of the zoning master plans throughout the country to expire on 1 January 2004 as a result of which a significant proportion of the real estate in the country is currently not zoned. Consequently, a hotel developer who acquires land without zoning will have to take into consideration that it may require as much as 12 months (or more) to obtain the correct zoning master plan and study or a planning permit for the plot that has been acquired.

**Slovakia** – Star rating: To date, Bratislava remains the only CEE capital without a five star hotel. The star award system is governed by national legislation, and investors are currently speculating whether the non-existence of five star accommodation is a result of the strict interpretation of the regulation and whether the planned Kempinski Hotel River Park, due to open in 2009, will manage to obtain such a rating.

Clearly, while CEE is often looked at as one region, it is much more relevant to view each CEE country separately, with the only common denominator being the now established, and largely functioning, market economy.

Therefore, whether you are contemplating investing in, developing or managing a hotel in CEE you should always ensure that your advisors have a local presence with a track record in hotel real estate transactions that shows they are familiar with the local issues and the most reliable and effective ways of resolving them.

*Sarka Robinson*
*Partner, Corporate, Prague*

*May 2006*

# Management contracts

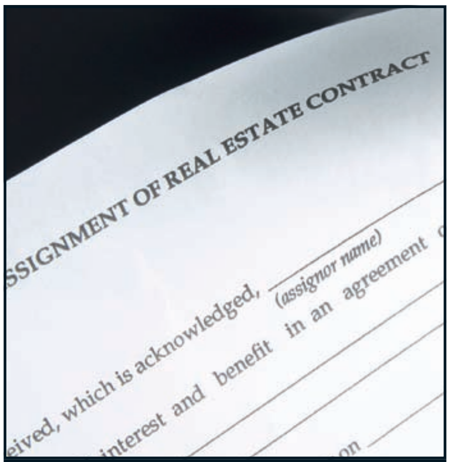
No doubt you have heard people say that the hotel management contract is an agreement like no other – under which the hotel operator can operate the owner's hotel pretty much as it pleases, at the owner's expense, normally for a significant period of time. Although this may be the case for some unnegotiated management contracts, this article aims to assist owners in understanding what to expect when negotiating a hotel management contract. In doing so, it sets out some of the key issues and what provisions can be sought to help strengthen an owner's position and ultimately increase the value of the asset.

So where do these negotiations start? Most operators begin with their internal "standard form" hotel management contract and although most standard forms are more owner-friendly than they were in the past, it is unlikely that a standard form will give an owner the protection it requires. However before an owner gets to the first draft stage, it is important that the heads of terms agreed between the parties sufficiently cover all of the key issues (some of which are discussed below). This will help an owner to negotiate away from the standard form, as it can be difficult to raise new issues during the contract negotiations.

### Sharing the Risk

The basic principle of a hotel management contract is that, unlike a lease, an owner takes all of the risk and liabilities of the business. The owner is also responsible for the hotel's assets, including maintaining the property, furnishings, fittings, inventory and funding the hotel's bank accounts. Accordingly, it is important that the operator is "incentivised" to take on some of the risks of the hotel's operation. This risk sharing goes beyond an operator having an incentive fee that is calculated as a percentage of the hotel's profit. An operator can provide "key money" (being an upfront payment for entering into a contract) or a guarantee of a level of profit to help share this risk. But the price of an operator agreeing to such terms may be reflected in the other commercial terms of the deal. More commonly, an operator will agree to defer some of its fees where there is insufficient profit to service the owner's debt. Although not a guarantee of profit, such deferral does help share some of the owner's financial burden, particularly in the early years of a hotel's operation. A management contract should specify how these deferred fees are treated, for example, whether there are any restrictions on earning back these fees or if any interest is payable on the deferred fees.

**The owner will often be required to fund replacements, upgrades and works to maintain brand standards**




Standard forms may not give adequate protection

Most contracts will require that a hotel be operated to the operator's brand standards, meaning that the owner will be required to fund replacements, upgrades and works to ensure that the hotel is maintained to the required standard. However, an operator should also be required to optimise the financial performance of the hotel. This type of provision should not be objected to by most operators and will give extra comfort to an owner.

### Approval of Key Matters

An owner should seek approval rights in relation to key liabilities of hotel's operation. Most operators will allow an owner to approve each annual budget for the hotel (although some only allow consultation rights). A management contract should specify what deviations from the approved budget are permitted (for example, a certain percentage above line items or an overall cap subject to increases in occupancy or costs).

Other types of decisions that can require an owner's approval include the appointment of the general manager, entering into high value and long-term contracts, material leases and initiating legal proceedings.

### Exclusivity

Owners will often ask for restrictions on the operator managing other nearby hotels although this is usually restricted to a particular brand.

### What to do with an underperforming hotel

It is important for a management contract to contain financial targets (or performance tests). Failure of an operator to achieve these targets will give the owner a right to terminate the management contract. These targets are usually based on ratios, by measuring performance against one or both of gross operating profit as a percentage of revenue and/or revenue per available room (RevPar) (which combines average room rate and occupancy). Financial targets are usually measured against a comparable set of hotels in the same marketplace, as this measures the hotel's performance to matters within the operator's control. Some contracts will give an operator the ability to cure a breach of a performance test, however the number of times an operator can cure the failure is limited.

**An operator may agree to defer some of its fees where there is insufficient profit to service the owner's debt**

### Selling or financing your hotel

Most management contracts will specify what happens if an owner wants to sell the hotel. Usually one or more of the provisions will apply:

- restrictions on the purchaser – including a prohibition on a sale to a competitor of the operator, someone who has insufficient net assets, is a criminal or has a poor business reputation. An owner should seek to have these categories as narrowly defined as possible;
- right of first refusal or pre-emption right – these offer the operator a right to purchase the hotel. These can often be onerous and may hinder an owner's sales process;
- termination upon sale provided that compensation is payable to the operator. This is a valuable right for the owner, as ability to sell the hotel free from the management contract significantly increases the potential sale price as it allows a wider choice of purchaser; and/or
- termination by the operator if certain criteria are not satisfied.

The above restrictions may also apply to a sale of shares in the owner and to a financier wanting to on-sell the hotel. Some management contracts may also contain restrictions on the owner's financing arrangements for the hotel.

Finally, when negotiating a hotel management contract, an owner should always bear in mind that the contract will form the basis of a long-term arrangement with the operator. As such, it should consider what an incoming purchaser (and their lenders) would be prepared to accept and if the terms are in line with market expectations.

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*January 2008*

# Ukraine & the European Cup

Businesses across Europe are waking up to the virtual explosion in property development taking place throughout Ukraine. However, as new shopping centres, office towers, and apartment and housing complexes spring up in the capital city, Kyiv, and across the country, hotel developments have been relatively neglected.

That's about to change dramatically. On the heels of UEFA's granting the 2012 European Cup to Ukraine and Poland, about €1bn (£720m) needs to be invested over the next four years to triple Ukraine's available hotel space to accommodate the estimated 1 million fans who will flock to the four Ukrainian match cities, Kyiv, L'viv, Dnipropetrovsk, and Donetsk to cheer on their teams. And that level of investment is only what's necessary to meet UEFA's requirements of 5500 four- and five-star hotel rooms (compared with 1600 currently) and 5600 two- and three-star hotel rooms (versus today's 3900). Further, as demand will for the foreseeable future continue to outstrip supply in this sector, these developments are likely to only meet current needs.

Ukraine is banking on the Euro Cup to continue to fuel its current economic boom. Dirck Smits van Oyen, head of Kyiv's ProMarketing consultancy and formerly the General Manager of Ukraine and Poland's successful bid, notes that: "UEFA made a powerful statement by bringing the Euro Cup to Eastern Europe for the first time in its history. The economic and tourism impact of these events on a host country can be profound. Germany experienced a significant boost in these areas after the 2006 World Cup, and Portugal, already a well-known tourism destination, saw a 10% surge in foreign visitors relative to pre-Euro Cup levels still two years after the event. The impact of the tournament on Ukraine and Poland is likely to be considerably bigger."

Recognising the potential of the Euro Cup as a spur to greater economic development is not enough. Smits van Oyen says that the governments of both countries understand that if people have nowhere to stay, they won't come. Or worse, they won't come back. Therefore, "a key part of the bid was an undertaking to facilitate an extremely dynamic five-year accommodation development strategy in all host cities."

It will be a challenge. Until now, hampered by a complex bureaucratic permitting environment, lack of obligatory hotel certification, high taxes, and a weak service culture, Ukraine's hotel sector has been slow to take off. By some estimates, only 5% to 10% of the nation's hotels are up to international standards.

However, things have recently started to turn around as the Ukrainian authorities have finally begun to move on their promises to UEFA. The Ukrainian government has developed a comprehensive state programme that not only includes infrastructure development projects (stadiums, roads, rails, hospitals), but support for the development of the accommodations sector. Measures are being readied to facilitate the investment needed to build hotels, including slashing onerous taxes to stimulate hotel expansion and construction; preparation of legislation to introduce obligatory hotel service-level certification to raise the quality of tourist service standards; streamlining the permitting and licensing process by establishing a "one-stop" application process; improvements to the management structure of the tourist sector at the national and regional levels; and upgrading the tourist infrastructure in host cities (such as tourist-friendly road signs).

The market seems to be paying attention. The State Statistics Committee of Ukraine reports that sales turnover at hotels between January and July 2007 increased to $283m (£141m) from $216m during the same period last year. DTZ, the property consultancy, estimates that out of a secondary transaction volume of $265m in 2006, about a third was invested in the hotels sector. DTZ projects total real estate transactions volumes to almost quadruple to $830m by the end of 2007, with some increase in hotel investment. This activity mostly involves assets in Kyiv and after years of effort, major international hotel developers and operators are now joining some small boutique operators in opening up in the city: Radisson (developed by Rezidor) is celebrating two years in the city and in September 2007 Hyatt welcomed the first visitors to its new showcase hotel. Both hotels consistently operate at or near 100% capacity, while the general occupancy rate in Kyiv is 60% and 80% in the city core. Soon to follow is the opening of new InterContinental, Hilton, and Sofitel hotels, along with a major development to be operated by Sheraton. Radisson, Hyatt, Marriott and Accor have announced plans to open hotels in other key Ukrainian cities, including Euro Cup matches locations.

**By some estimates, only 5% to 10% of hotels are up to international standards**

In fact, the most promising growth in this sector is connected with the development of quality and affordable two- and three-star hotels. Businessmen come and go, but Ukrainians and tourists have a hard time finding decent value accommodations when traveling through towns and the scenic countryside. The increasing affluence of the general population and the rise in the past few years of a vibrant, consumer-oriented middle class is convincing operators looking to expand their two- to three-star value brands, such as Hilton, Accor, and Marriott, that this sector can be sustainable, and profitable, over the long term.

With demand considerably exceeding supply, the hotel boom starting in Ukraine is set to continue beyond the final whistle of the European Cup tournament. Yields in the hotel sector are compressing (hovering at just below 10%), and while payback in the sector can take between 10 to 12 years in Europe, it is estimated at between six to nine years in Ukraine. With its shiny church domes, Byzantine-baroque architecture, restaurants, parks, and storied history, Kyiv is still untapped as a potential major congress and convention centre. In addition to the other host cities (including alternates Odessa and Kharkiv), smaller cities in the regions are ramping up their business and tourist potential. Innovative projects being prepared in some locations include hotels in multi-purpose or mixed-use developments, such as stadiums and shopping and office complexes.

However, the success of these prospects depends on whether the Ukrainian government delivers on its promises to considerably improve the country's creaky infrastructure and reduce corruption in the permitting process, problems that have stymied the development of the hotels sector for so long. Also, as the hotels business becomes increasingly competitive, new entrants into the market may find a shortage of high quality local development and construction partners with the technical capability to meet international standards and to effectively manage relations with local authorities.

The market has signaled that it is prepared to take the government at its word and continued growth in the hotels sector in Ukraine is expected for the foreseeable future. Building scores of quality hotel accommodations at all levels throughout the country will do much to burnish the nation's image, stimulate tourism and can create a virtuous cycle of investment in infrastructure and many other segments of the Ukrainian economy. Pledges by the government to improve the transparency and predictability of the Ukrainian property regime will strengthen and stabilise land ownership and leasing, which will continue to support the expansion of credit markets and stimulate investment and overall economic growth.

At the end of the day, hosting the 2012 European Cup is much more than about football – it is an opportunity for Ukraine to secure its future economic development.

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*Head of CMS Central and Eastern European Hotel & Leisure Group*

*December 2007*

# Looking forward to the end of term

Record numbers of hotels have changed hands over the last few years. Many sold by the big operators have been the subject of manage back deals using management agreements. However a significant number have been the subject of leasebacks or new leases. Although many of the large operators may prefer management contracts, many investors and some operators prefer leases, so the lease is likely to be 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 oblige the tenant at the end of the term to "yield up" the property in good repair.

However leases of hotels 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 its right to a statutory renewal such as under the English Landlord and Tenant Act 1954. On renewal the termination provisions will not apply. However one cannot assume that renewals will go on for ever. At some stage the tenant will move out, perhaps because the landlord wishes to operate the hotel business itself. 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 now whether it 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 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.


Extra initial work will be time well spent

**Leases of hotels should be different from leases of other property assets because hotels form a very different asset class**

## Staff

If the landlord acquires the business, EU employment law such as the UK Transfer of Undertaking Regulations will automatically pass over responsibility for staff to the landlord as the new business operator. However there may 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 be permitted to use it under the lease. However the name may belong to a third party (for instance one of the big operators) under a franchise agreement. Can arrangements be made now to enable the landlord to take over that franchise agreement in the future? Whilst 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 it owns it, to transfer the goodwill in 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 the landlord itself) 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 which straddle the handover of the business. The lease should provide for appropriate payments adjustments and debt collection arrangements between landlord and 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 may be a going concern transfer which avoids the need to pay VAT, but the landlord will need to register for VAT purposes. The lease should state VAT requirement and deal with all other taxes relevant to a hotel operation such as tax on employees' pay. 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 business and will include VAT, employment, booking and 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 may be entitled to compensation from the landlord at the end of the term. Most 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.

Considering all these arrangements at the start rather than 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 handover arrangements between them.

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*September 2006*

# Bedbug attacks

"Sleep tight, don't let the bedbugs bite" is no longer a saying for children but a warning for the hotel industry.

A US couple are bringing a multi-million dollar case in New York against the Mandarin Oriental Hotel Group. The couple stayed at the Mandarin Oriental in Knightsbridge, London and claim hundreds of bedbugs "attacked" them during their five night stay resulting in painful, red, itchy eruptions.

They claim not only to have been forced to obtain medical care for their physical and emotional injuries but, to add insult to injury, the little critters decided to travel back with the couple to their Manhattan apartment.

Allegedly, their apartment had to be fumigated, numerous belongings destroyed and the couple claim that they are still suffering both emotionally and physically.

The Mandarin Oriental Group is accused of negligence, recklessness, fraud, intentional infliction of emotional distress, nuisance and deceptive trade practices. The couple are seeking compensatory and punitive damages in excess of $3m (£2m), as they want to punish Mandarin for its alleged failure to provide them with suitable accommodation and its alleged failures properly to deal with the matter afterwards.

The claim is being brought against eight defendants, all of which are interrelated group companies, two of which are US corporations. The couple's attorneys argue that the New York district court should hear the claim because the Mandarin Oriental Group "have offices and conduct systematic and continuous business" in the district; and because the couple suffered "continuous and new injuries and damages" in the district. An early challenge to jurisdiction might be expected.

**An opera singer sued for $6m claiming she suffered over 100 bites, which was "not going to help her romantic life or career"**

To the English reader this may seem unusual but there are numerous other cases in the US, where similar claims have and are being made against hotels.

These include a successful claim in Illinois against Accor Econ Loding Inc, in which two Chicago trade show attendees who found their Motel 6 hotel room overrun with bedbugs, were each awarded $5,000 in compensatory damages and $186,000 in punitive damages. In this instance, it was found that the hotel management did little or nothing to address the problem of which it had been aware since 1998.

Other cases currently pursued in the US include a claim where a mother is suing the Marriott hotel group in relation to over a thousand bites suffered by her children while staying at Disneyland Florida. Further, in January 2007, a New York opera singer sued the Hilton Hotel chain for $6m claiming she suffered more than 100 bites which was "not going to help [her] romantic life or [her] career".

The common thread in all these cases is that the hotels did not act appropriately once they became aware of the infestations.

An equivalent claim in England and Wales against a hotel would probably involve claims for negligence, breach of the Supply of Goods and Services Act 1982 (the "Act"), breach of the duty under the Occupiers' Liability Act 1957, subject to the terms of the guest's contract with the hotel and breaches of certain implied terms of that contract. An infested room could well breach the implied condition (under the Act) that the hotel is not carrying out its services with reasonable care and skill and an imaginative lawyer might come up with any number of additional implied terms.

In the UK, a spate of bedbug infestations occurred between 1999 and 2001. The Grand Hotel in Brighton had an embarrassing outbreak of bedbugs at the height of the 2005 Labour Party Conference. Most of the claims arising out of bedbug incidents were reportedly settled by a reduction in charges (an indication of the likely modest sums involved in such claims) and the claims did not reach the Courts. One defence filed in the County Court, but never tested in proceedings, asserted that the Claimant could have brought the bugs into the hotel himself, as they have been known to travel in the turn-ups of trousers.

The real distinction between bringing a bedbug claim in the US and bringing a claim in England and Wales is the level of recoverable damages.

In England and Wales it is very rare for punitive damages to be awarded. The concept of damages in England and Wales is to compensate for the loss caused. Exemplary damages, which are punitive, are rarely awarded and indeed can only be awarded where the defendant deliberately and outrageously disregards the claimant's rights.

It is highly unlikely that a bedbug case could be shown that a hotel 'outrageously' disregarded a guest's rights, especially if it offered to reimburse its guest in any way for his or her costs.

Realistically, any bedbug claim against a hotel in the UK would result in minimal damages being awarded due to the short-term discomfort suffered by the victim, unless they are able to show otherwise. When assessing damages in respect of non-pecuniary loss an English court will normally award a lump sum in respect of "pain and suffering and loss of amenities" and special damages for any relevant extra costs incurred.

The level of damages varies in the US and England

**The couple are seeking damages in excess of $3m as they want to punish Mandarin Oriental Group for its alleged failures**

A leaf through Kemp and Kemp, the authoritative guide to personal injury damages in the English Courts, does not reveal any damages awarded as a consequence of bedbug bites. Comparable examples include: £2,000 awarded to two children in an approved settlement (as they were minors) after they suffered insect bites and developed a disease due to a cockroach infestation at their home; £500 awarded for soft tissue injury and bruising to the lower body after the claimant was thrown from his motorcycle; and £3,000 awarded for extensive abrasions to the knee together with grazing and bruising when the claimant was knocked over and stood on by a police horse.

This general approach in the English Courts however, does not mean that hotels in the UK are not at risk. What the case against the Mandarin Oriental Group highlights is the cross-border litigation risk that could arise for any hotel anywhere. US residents can claim substantial damages by bringing their bedbug and other claims in the US and undoubtedly the availability of punitive damages will be an important factor in the choice of Courts.

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*March 2007*

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