

LEGAL ASPECTS THE HOTEL BUSINESS IN THE RUSSIAN FEDERATION

Despite the successful work in Russia of representatives of the international hotel business, in many Russian cities there are still not enough decent hotels (primarily medium price range hotels). Moreover, this situation is characteristic not only for the regions, but also for such cities as Moscow and St. Petersburg, where the development of hotel infrastructure and tourism is actively supported by city authorities.

However, before starting to develop this highly attractive market a foreign investor should be familiar with certain rules and features. This newsletter provides a glimpse of general legal grounds and law enforcement practice as concerns hotel construction and operation in the Russian Federation.

1. HOTEL CONSTRUCTION AND OPERATION

Classification

While implementing a project for constructing and operating a hotel one of the most important issues is that of its belonging to a certain category (by number of "stars"). Due to the lack of a uniform hotel classification system, various countries have their own systems.

In the Russian Federation a national system for classifying hotels was introduced in 2005. Participation in classification is voluntary. A category certificate, issued for 5 years, entitles hotel owners to use the label of a particular category (by number of "stars").

Lacking such a certificate a hotel does not have the right to use a category label and may not state a particular category in outdoor advertising or refer to one in information sources. If this rule is broken the organization operating the hotel (hereinafter "hotel operator") may be held liable.

Construction and commissioning

If erecting a hotel in accordance with a certain standard is planned, it is very important that particular conditions based on the Russian classification requirements, are observed as early as the stage of developing the contract documentation for

construction. Furthermore, note should be taken of compliance with the particular requirements of the hotel operator or the special requirements of the specific hotel chain.

If a hotel operator is simultaneously both the investor and the future owner of the hotel, it is sufficient to include the necessary requirements into the respective contractor agreements for design and construction work. However, it is more common that the organization operating a hotel is not the owner. In such case, in practice either a preliminary agreement (for example, a preliminary lease agreement for the hotel) or a consulting services agreement is entered into. At this stage the future hotel operator consults the owner on technical issues, including those concerning the functional design, procuring required equipment, obtaining licenses, and selecting and training personnel.

After construction is completed all project participants strive by all means to commission the hotel as quickly as possible. A commissioning permit is the official confirmation of the completion of construction work and the document required for registration of title by the respective state authority. Given that the commissioning of a hotel is quite a long process, a hotel building is oftentimes used before a permit is obtained and the title registered. Certain risks arise in such case, namely:

- commissioning a hotel in the absence of a corresponding permit is an administrative offense and may entail a monetary fine;
- problems may emerge in obtaining licenses and other permit documentation, during the issuance of which the existence of duly registered title to the real estate is verified;
- expenses for leasing a building that has not been registered as a real estate object are not taken as a deduction during taxation.

Required licenses

Preliminary obtaining a license is required in order to carry out certain types of activities when operating a hotel. Another option is to enter into an agreement for the respective services with specialized organizations that already have this license. Such types of activities related to maintaining a hotel primarily include:

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- retailing alcoholic beverages¹ and
- banking services which may be rendered only by specialized lending institutions (banks), for example operations related to use of ATMs and credit card servicing terminals, as well as currency exchange operations (in cash or non-cash form)².

Conversely, special licensing is not required for such types of activities as renting rooms and apartments, selling food and drink, cigarettes and tobacco products, operating health facilities and saunas, as well as subleasing premises for locating trade and service enterprises.

2. AGREEMENTS RELATED TO OPERATING A HOTEL

Application

If, as in most cases, the hotel operator is not the hotel owner, its relations with the owner must be executed by contract. This concerns design and construction; commissioning and subsequent operation of the hotel and in practice is carried out by way of entering into several civil agreements of different types, or agreements of a combined type immediately regulating several aspects of the relations between the owner and the operator. The choice of the art of agreement depends on the parties' economic interests.

We next touch on the general rules important by signing agreements and certain features of entering into preliminary agreements and then list the main characteristics of the most common types of agreements related to operating a hotel.

Governing law

When entering into agreements in Russia foreign hotel operators frequently seek to subordinate them to the laws of a foreign state. This possibility exists in principle, but there are a number of restrictions:

- The imperative (mandatory) provisions of Russian law will be in effect regardless of the choice of an agreement's governing law. For example, this concerns requirements regarding obtaining licenses (described above), compensating for damages in the event harm is caused to health and lives of people as well as in connection with the

invalidity of transactions conducted for reasons contrary to principles of public order and morality. In this regard, in each separate case it is necessary to verify whether an agreement meets the requirements of these imperative provisions. Otherwise effective protection in the course of judicial proceedings in a Russian court or in the context of enforcement in Russia will not be possible.

- Agreements regarding real estate located in Russia are subject to obligatory regulation by Russian legislative provisions. In this regard, if a hotel operator intends to subject an agreement to foreign law, the provisions related to real estate must be fixed in a separate document that will satisfy the requirements of Russian legislation.

Dispute resolution

Agreements with foreign hotel operators often contain provisions on resolving disputes in an international arbitration court. However, concerning disputes related to real estate located in Russia or rights thereto Russian procedural law stipulates a requirement on the exclusive jurisdiction of state arbitration courts of the Russian Federation. This requirement is also applicable to foreign companies.

An award of a foreign arbitration court may be executed in the Russian Federation only if it is acknowledged by a Russian court. However, considering the foregoing requirement on exclusive jurisdiction, such awards of foreign courts or international arbitration courts concerning real estate are not acknowledged by Russian courts.

Tax aspects

In the course of legal relations between subjects of various jurisdictions risks of double taxation generally arise and consequently questions of tax optimization emerge. In this regard, it is very important to analyze any agreement pertaining to a hotel business from the standpoint of tax law. In particular, in order to ensure the future possibility to deduct expenses for profit taxation purposes, it is necessary to clearly articulate the subject of the agreement.

Preliminary agreements and their application

Prior to the start of actual hotel operation and management, in practice preliminary agreements are often entered into. Moreover, the most common form is that of a preliminary hotel lease agreement.

¹ Federal Law dated 22 November 1995 No. 171-FZ "On State Regulation of Production and Trafficking of Ethyl Alcohol, Alcoholic and Alcohol-Containing Products".

² Federal Law dated 2 December 1990 No. 395-1 "On Banks and Banking Activities".

Despite that such preliminary lease agreements are quite frequently entered into at the construction stage, the issue of their legal force has not been unambiguously decided by court practice. There is, for example, the risk that a preliminary agreement may be disputed through a judicial procedure due to lacking a precise definition of the subject of lease. Considering existing court practice, an object for which parties enter into a lease agreement must be defined by way of describing it in detail, drawing up a plan of the object, and by referring to the cadastral number of the corresponding land plot.

Even before entering into the main agreement parties often supplement a preliminary lease agreement with several additional conditions regulating their further mutual relations. For example, this includes provisions on performing finishing work or on equipping the hotel. However, pursuant to Russian legislation a preliminary agreement may not contain conditions for entering into the main agreement that depend upon the will of the parties. In this regard, it is necessary to formulate the said additional conditions as a required essential characteristic of the object as well as to define the corresponding obligations of the parties. Furthermore, a preliminary agreement must state the deadline by which the parties shall enter into the main agreement; otherwise the legislatively established condition stipulating that the parties' obligations terminate upon the lapse of one year will apply.

In practice, a tenant's intentions often include using the leased object even during the validity of the preliminary agreement. The tenant's right to access the leased object is fixed in a so-called "access certificate". Such a certificate confirms not only the actual use of the property, but also the owner's right to receive the corresponding fees. However, court practice is yet to have definitively decided the issue of the legality of charging the said fees. Therefore, there is still a risk of it being impossible to enforce the collection of such fees.

3. MAIN TYPES OF AGREEMENTS

Lease agreement

Under a hotel lease agreement the landlord (hotel owner) undertakes to transfer the hotel to the tenant (hotel operator) for temporary possession and use (for lease) in a condition suitable for use and fully ready for operation. In turn, the tenant undertakes to accept the hotel for temporary possession and use and pay rent. Generally a hotel lease agreement is entered into for a long term (for example 10 or 20 years).

The hotel operator may make the portion of investments required for interior decorations of premises and rooms and

take on expenses for maintaining the real estate. Furthermore, the hotel operator undertakes to manage the hotel and bear the associated risks.

One of the peculiarities lies in the fact that construction issues and lease issues in Russia may not be regulated within the framework of one agreement. In this regard, entering into a lease agreement and consequently transferring a hotel is possible only after the completion of the construction and the registration of the landlord's title to the hotel building.

A lease agreement for real estate located in Russia must be regulated by Russian law. Moreover, a hotel lease agreement entered into for a term of one year or more is subject to state registration. Such an agreement enters into force only upon its registration in the Unified State Register of Rights to Real Estate and Transactions Therewith.

Management agreement

When a hotel management agreement is entered into risks are distributed between the owner and the hotel operator. The subject of a management agreement is the rendering of services for management of a hotel by a management organization acting as an agent on behalf and at the expense of the owner.

An agreement with a management organization is usually a framework agreement stipulating fundamental conditions (the parties' rights and obligations). Such conditions are to be concretized in separate agreements being annexes to the framework agreement (for example, in a license agreement on transferring rights to use a trademark, an agreement on assigning personnel, an agreement on rendering marketing services for reservations, an advertising services agreement).

After the facility is commissioned the management organization assumes the functions of controlling and managing the hotel. In particular, the management organization's authority covers issues of pricing, maintaining accounting, agreements with tenants, ensuring the proper condition of hotel property, procuring supplies and inventory, as well as participating in an integrated reservation system of the hotel chain.

The management organization receives a fee for its services. Since in this case there is no assignment of rights to the building as real estate, the expenses for maintaining the hotel building are borne by the owner.

Commercial concession agreements (franchising agreements)

Under a franchising agreement the owner manages the hotel itself, using know-how of the franchisor, which is generally

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a foreign hotel chain. The franchisor grants the owner a set of rights to use a trademark and know-how for managing the hotel, renders routine consulting services for management issues, ensures personnel training and provides support in matters of marketing and participating in a general reservations system.

As a whole, the services rendered by a franchisor are in many aspects similar to the tasks of a management company. However, within the framework of a franchising agreement the management of the hotel is in fact performed by the owner (or an organization it engages) and it bears the business risks. It should be noted that in Russia franchise agreements (so-called "commercial concession agreements") are subject to state registration with the authorized bodies.

The hotel owner is liable for compliance with the quality standards assumed within the context of the respective franchising system. As in the case of entering into a management agreement, negotiations concerning franchising should be held at the stage of designing the hotel, when all technical requirements for allocating areas and equipping premises can be taken into account.

4. ANNEX: LEGAL FRAMEWORK

When activities are carried out for rendering hotel services in the Russian Federation a number of regulatory legal acts should be taken into consideration, the most important of which are:

- the Civil Code of the Russian Federation;
- the Law of the Russian Federation No. 2300-1 dated 7 February 1992 "On the Protection of Consumer Rights";
- the Decree of the Government of the Russian Federation No. 490 dated 25 April 1997 "On Approval of the Rules for Providing Hotel Services in the Russian Federation";

- the Decree of Gosstandart of the Russian Federation No. 82 dated 26 September 2001 "On Establishment and State Registration of the System of Voluntary Certification of Services of Hotels and Other Accommodations in a Category. Ross ru. 0001.03UG00";
- Order of the Federal Tourism Agency (Rostourism) No. 86 dated 21 July 2005 "On Approval of the System for Classifying Hotels and Other Accommodations";
- National standard of the Russian Federation "Tourism Services. Accommodations. General Requirements. GOST R 51185-2008", approved by Order of the Federal Agency for Technical Regulation and Metrology No. 518-st dated 18 December 2008.



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