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Structuring Condominium Hotels

These properties require complex relationships and agreements.

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One of the most innovative and complex forms of real estate ownership is the condominium hotel, which is the ownership structure of some of the most luxurious properties in New York and throughout the world.

However, regardless of whether the hotel and the residential units are luxurious or merely utilitarian, condo hotels require a complex set of relationships and agreements in order to function properly. In many instances some of the hotel rooms are offered as condominium units, and in others the hotel rooms are adjacent to the residential units or are on different floors, but the common factor is that the residential unit owners have the ability to utilize hotel amenities and services.

The interest in condominium hotels has increased as a result of a confluence of factors, including: (a) condominium pre-sales can reduce the risk faced by construction lenders; (b) the addition of the hotel's amenities and, possibly, a rental program, provides the developer with a premium over the sales price for condominium units without access to hotel amenities; (c) condominium hotels enable consumers to own real estate for personal, investment and vacation use, while potential rental income helps defray the cost of ownership; and (d) hotel operators obtain a new supply of hotels, without being required to invest capital in the property.

However, there are major issues to consider in developing and operating con-

dominium hotels because of the complex relationships and potential conflicts arising from competing interests in the various components of the condominium as well as finding a mechanism to share the cost of providing the amenities and services. This also necessitates placing limitations on the residential board in order to protect and preserve the right to use the hotel brand and trademarks.

Condominium Issues

The New York Condominium Act,¹ which was enacted in 1964 and has been virtually unchanged for almost 50 years, does not contemplate condominium hotels (or much else that is now commonly done in New York and throughout the country), resulting in complex declarations and bylaws to deal with all the operating and ownership issues involved in these elaborate structures and multifaceted relationships. The issues that must be considered are the relative power and authority of the unit owners and the board and, in many condominiums, the relationship of the condominium and residential boards over the general and limited common elements including allocating the cost and control of their maintenance, repair and replacement.

Purchasers of the condominium units are concerned about preserving their equity and maintaining their quality of life, which creates a situation where they would like to be able to



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control the operating costs, but doing so can jeopardize the value of their units. Similarly, the hotel owner has a paramount concern about protecting its ability to use the hotel's brand and does not want a residential board to control the public portions of the building and run the risk that a board will be elected that will attempt to avoid necessary operating costs. As a result, the ownership structure is almost always bifurcated, where the residential board deals with the interior of the residential section and where the general common elements is under the supervision of the condominium board, which is either not controlled by the residential owners or, when it is controlled by them, has limited authority. This article points out the reasons for the severance of control.

Generally, the issues that require special attention in drafting the declaration and bylaws

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of the condominium are (a) establishing the units and the general and limited common elements; (b) allocating the percentage interest in the common elements in compliance with RPL §339-i; (c) determining the power and authority of the board or boards; (d) determining what happens on a casualty or condemnation; (e) allocating expenses that only apply to certain sections (hotel, residential, retail, office or other); and long-term planning relating to repair and replacement of the structural portions of the building. Each of the foregoing have to be accomplished in compliance with the Condominium Act and fully disclosed in the Offering Plan.

Brand Issues

The most unique feature of a hotel condominium is the use of a hotel's brand and trademarks that are used in conjunction with the hotel, which necessitates that the owner of the brand make certain that the entire property is maintained and operated in accordance with the brand's standards. It is important to note that only in rare circumstances are hotels owned by the owner of the brand; hotels are usually owned by developers or investors and are either managed or operated by the owner of the brand or pursuant to a license to use the brand. However, under any ownership structure, the condo hotel can only use the brand and its trademarks as long as there is strict compliance with the brand's standards, which means that both the hotel operator and owner must make certain that the condo unit owners and boards not take any action that could jeopardize the continued use of the brand.

The issues that arise as a result of the need for the hotel to be branded include: the owner of the brand will want the entire condominium operated in a manner that is consistent with the reputation of the brand (i.e., the brand standard); the purchasers of the individual units will be required to confirm that they have no right to use the brand or its trademarks; the condominium offering plan and documents must reflect the fact that the relationship between the brand and the hotel owner and the condominium can be terminated and, if it is terminated, all use of the brand and the trademarks must be discontinued immediately. Moreover, the owner of the brand will also be concerned about the nature of the services that will be provided to the condo unit owners and hotel guests, the condition and appearance of the condominium and whether the cost of the services will be absorbed into the common charges or will be separately charged to the unit owners who utilize such services.

In order to make certain that the relationships are protected, the Offering Plan, the condominium declaration, and frequently the residential unit's purchase agreement, will identify the rights and obligations of the various parties, particularly with regard to the brand. Although the hotel unit is separate from the residential unit and the residential board has no involvement in the operation of the hotel, the declaration frequently requires that the residential board comply with the brand standards because the residential section is part of the condominium that bears the brand. It would be difficult for a luxury hotel brand to remain on the hotel unit if the hallways in the residential section were shabby or laundry was hanging out the windows of the residential section. In fact, this concern over quality is in everyone's best interest because, if the hotel loses its brand and is unable to obtain a comparable replacement brand, the value of every residential unit will suffer.

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The owner of the hotel brand will want to make certain that its investment in the hotel unit is not adversely affected by a failure of the hotel unit owner to comply with the terms and conditions of the declaration and other governing documents. The hotel unit owner's lender will also want to make certain that the owner of the brand will not use the failure of the hotel unit owner to comply with the brand standards to terminate the operating or management agreement, thereby reducing the value of the collateral for the loan. This concern extends to the lender making certain that the manager signs a subordination and non-disturbance agreement which, in hotel financings, is a critically important document.

Moreover, regardless of whether the hotel owner or manager is using part of the hotel for time shares or interval ownership, neither the hotel manager nor the hotel unit owner would want the residential units to be used for any kind of occupancy plans, so the declaration will also specifically preclude the unit own-

ers from including their units in any kind of time share or similar enterprise, which could have an adverse impact on the hotel and the brand's image.

Shared Facilities

In a typical condominium hotel project, the parties cede to the operator all management and operational control over those aspects of the project that are necessary for the hotel operator to operate the hotel. In order to achieve this goal, part of the area and facilities that would ordinarily be considered "common elements" are either designated as part of the hotel or are retained in the condominium but designated as a commercial condominium unit owned by the developer or the operator, with portions designated as "shared facilities," that are available to the unit owners and the hotel guests.

The shared facilities may include elevators, lobbies, fitness centers, business centers, the restaurant and meeting rooms, which are frequently located within the hotel unit or controlled by the hotel unit owner, but are available for use by all the unit owners through the right to a non-exclusive access, ingress and egress to, from and through certain portions of the hotel. This right to use the shared facilities is coupled with a payment obligation, in which the unit owners are obligated to pay their pro-rata share of the expenses relating to the operation, maintenance, repair and replacement of the shared facilities. The rights and obligations relating to the shared facilities are contained within the condominium declaration.

Hotel Management

Another key document in the operation of the condominium hotel is the hotel management or operating agreement between the hotel owner and the manager or operator of the hotel in which the manager operates the hotel on behalf of the owner. The manager takes reservations, conducts marketing, and, most significantly, arranges for the maintenance, repair and replacement of the hotel and its furniture, fixtures and equipment, which expenses must be approved and paid for by the hotel owner.

Among the issues to be negotiated between the hotel owner and manager include the fees, which are usually based on a guaranteed base amount, that the manager calculated as a percentage of revenue from the hotel, plus an incentive element to be earned by the manager if gross operating profit exceeds a certain threshold and/or revenue per available room and room occupancy rates. The owner will

want the management agreement to limit the manager's ability to generate expenses while the manager will want to increase expenditures, which can result in higher fees for the manager. Of course, both would be concerned about maintaining the brand standards, but the hotel owner and manager may have differing interpretations of those standards, and each will want the condominium unit owners to share some responsibility for them

Another issue to be negotiated is the term and renewal of the management agreement, the hotel owner's obligation to provide working capital or otherwise finance the operation of the hotel including the cost and frequency of replacing furniture, fixtures and equipment because of excessive wear and tear and the need to keep them in good condition and appearance to increase the hotel's revenue and maintain the brand standards. Another issue that requires negotiation would be limiting the manager's ability to operate competing hotels in the same geographic areas as this hotel. The owner will seek the right to terminate the management agreement if the manager defaults under the agreement, without incurring any liability or if the owner does not meet certain predetermined returns. Other issues in the management agreement would be what happens on the expiration or other termination of the agreement in order to permit a seamless transition, the possible investment by the manager or operator, personnel, financial reporting, dispute resolution, and pre-opening expenses and technical assistance.

One difficulty for hotel management companies is a line of decisions that arose from California cases² culminating in the Third Circuit's decision in *Government Guarantee Fund of the Republic of Finland v. Hyatt*,³ which held that hotel management agreements were agency agreements that could be terminated by the hotel owner at will, but subject to damages if the termination was without cause. These decisions have resulted in attempts to change the nature of the relationship, including unbundling the services charged by the manager so there are separate payment streams.

Securities Issues

Condominium hotel projects can be further complicated when the purchaser is offered the option to include the residential unit in a voluntary "rental program" with the developer or manager of the condominium. In exchange for its participation in the rental program, the owner shares in the rental income. Rentals can be made specific to particular units or they can be "pooled," although that entails the risk that the offering may be considered a

security by the Securities and Exchange Commission and require registration, although the risk of being considered a security may no longer be an issue.

As a result of the U.S. Supreme Court's decision in *SEC v. W.J. Howey*,⁴ the SEC, in its Condominium Releases,⁵ held that a condominium unit could be treated as a security if it is offered in conjunction with (i) emphasis on economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, from rental of the units; (ii) the offering of participation in a rental pool; or (iii) the offering of a rental or similar arrangement whereby the owner must hold the unit available for rental for any part of the year, must use an exclusive rental agent or is otherwise materially restricted in his occupancy or rental of his unit.

The most unique feature of a hotel condominium is the use of a **hotel's brand and trademarks**, which necessitates that the brand's owner make certain that the entire property is **maintained and operated in accordance with the brand's standards**.

Subsequently, in a 2002 Private Letter Ruling,⁶ the SEC modified its position and permitted written and oral sales and promotional material to contain a statement that the "ownership may include the opportunity to place your unit in a rental arrangement" providing that, inter alia, there is no emphasis on economic benefits the purchaser may receive from the managerial efforts of a third-party manager/operator of the project, and that during the marketing and sales process, the real estate sales personnel may mention a rental program to the prospective purchasers as an optional services available to owners. However, real estate personnel may not provide prospective purchasers with information—even if publicly available—regarding the rental history of comparable units and can only respond to a specific inquiry from a potential purchaser. The restrictions have been an impediment to the sale of condo hotel units as well as unsold condominium units that require management expertise to make them profitable.

However, a small change in the federal securities laws contained in the Jumpstart Our Business Startups Act (the JOBS Act)⁷ could be used to permit the nationwide sale of condominium units with (or without) rental pools without the need for the sponsor to register the offerings with the SEC. The JOBS Act permits sponsors to acknowledge that the units are securities, but by expanding an exemption under Regulation D, obviates the need to register with the SEC if all of the investors are accredited investors.⁸ Rule 506 of Regulation D is a safe harbor from the registration requirements of the Securities Act of 1933,⁹ that allowed issuers to sell unregistered securities to an unlimited number of accredited investors and a limited number of non-accredited investors. Prior to the JOBS Act, Rule 502 of Regulation D prohibited the general solicitation or advertisement of securities in Rule 506 offerings. However, the JOBS Act has reversed that limitation and permits the general solicitation and advertisement of a Rule 506 offering, as long as all purchasers are accredited investors. Accordingly, sponsors should now be able to offer the units nationwide without doing an SEC registration if they comply with Blue Sky laws in states where sales are made.



1. Real Property Law Article 9-B (§339-d et seq.).

2. See *Woolley v. Embassy Suites*, 227 Cal. App. 3d 1520, 278 Cal. Rptr. 719 (1991); *Pacific Landmark Hotel v. Marriott Hotels*, 19 Cal. App. 4th 615, 23 Cal. Rptr. 2d 555 (1993).

3. 95 F.3d 291 (3d Cir. 1996).

4. 328 U.S. 293 (1946).

5. Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sales of Condominiums or Units in a Real Estate Development, SEC Release 33-5347 (Jan. 4, 1973).

6. Intrawest, SEC No-Action Letter (Nov. 8, 2002).

7. Public Law 112-106 (April 5, 2012)

8. 17 C.F.R. §230.501 et seq.

9. 15 U.S.C. 77a et seq.