

CONDO-HOTELS:

HOW DEVELOPERS AND OWNERS' ASSOCIATIONS CAN AVERT A HOTEL IMPLOSION

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Professional Experience

Joined Graham & Dunn, 1980

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Irv chairs the firm's Hospitality, Beverage & Franchise Team. He and his team counsel hospitality companies about acquiring, financing, managing, and franchising properties; developing and protecting technology, brands, e-commerce solutions, and other intellectual property; real estate associated with resorts, hotels and restaurants; negotiating and drafting system license agreements, management agreements, strategic partnerships, and other relationships; managing employment and diversity matters; restructuring troubled properties; and litigating disputes. Over the last several years, Irv has served as lead counsel in over 150 transactions involving over 100 different hotels worldwide, including complex acquisition structuring and condominium hotels. Irv is Chair of the American Bar Association's Hospitality Industry Liaison Subcommittee, is a charter member of the Academy of Hospitality Attorneys, is a founding member of The Lodging Roundtable, and is an executive board member of Seattle-King County Convention & Visitors Bureau.

Irv relies on his broad business law experience accumulated in over 25 years of service as a Graham & Dunn lawyer. Irv litigated business cases from 1980 to 1983. From 1983 to 1993 he established a recognized corporate recovery and turnaround practice, working with distressed companies, including hotels, both inside and outside of court protection. In so doing, he assisted hotel companies to successfully address a vast range of corporate, financial, business, transactional, and courtroom challenges. Irv served as Chair of the Washington State Bar Association's 800-member Creditor Debtor Section from 1988 to 1990, and was appointed in 1994 for listing in *The Best Lawyers in America* (Business Reorganization). Since 1992, Irv has served clients' broader business needs, focusing on client industry and culture, and applying the sense of urgency and comprehensive legal knowledge he gained in his corporate recovery work. He has chaired the firm's Hospitality team since its formation in 1993.

Professional and Community Activities

American Bar Association Hospitality Industry Liaison Subcommittee, Chair (2002-)

American Bar Association Hotels, Resorts and Tourism Committee, Co-Chair (2001-04)

Academy of Hospitality Attorneys, charter member (1997-)

Seattle – King County Convention and Visitors Bureau, Board Member (2002-)

Graham & Dunn Corporate Service Group, Chair (1993-97); Hospitality Industry Team, Chair (1997-)

Washington State Bar Association Creditor/Debtor Section, Chair (1988-90); Editor of *The Creditor/Debtor Newsletter* (1983-)

Seattle Rotary #4 (1989-); Leader, Rotary Hospitality Industry Circle (2005-)
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Education

M32995-665218_7

Representative Lectures and Panel Presentations

Panelist, "Condo Hotels," The Lodging Conference, Phoenix (September 30, 2005).

Moderator, "Mixed-Use Review," The Lodging Conference, Phoenix (September 29, 2005).

Moderator and Panelist, "Hotel Revolution-Are we Becoming a Condo Nation," American Bar Association Joint Fall CLE Meeting, San Francisco (September 15, 2005).

Moderator, "Acquisition, Development and Financing Issues: Focus on Condominium Hotels," The Hospitality Law Conference, Houston (February 4, 2005).

Moderator, "Mixed-Use/Hotel Condominium Development," The Lodging Conference, Phoenix (September 20, 2004).

Panelist, "Internet Issues of Interest to Hospitality Client," Academy of Hospitality Industry Attorneys, Seattle (May 14, 2004).

Co-chair, "The Legal Strategy Behind a Successful Mixed-Use Project: The Implication of Use Restrictions and Zoning," American Bar Association Spring Symposium, Seattle (May 14, 2004).

Panelist, "Hotel Mixed-Use Development Projects," The Hospitality Law Conference, Houston (January 22, 2004).

Panelist, "Deal Makers Forum," The Lodging Conference, Phoenix (October 17, 2003).

Panelist, "Risking Success: Buying an Under-Performing Hotel," The Lodging Conference, Phoenix (October 17, 2003).

Panelist, "Sale and Acquisition Concerns Arising from Hospitality Property Transactions: Buying and Selling a 'Business in a Box'," The Hospitality Law Conference, Houston (January 24, 2003).

Panelist, "Avoiding a Lawsuit: Strategies to Protect You and Your Hotel," The Lodging Conference, Phoenix (October 4, 2002).

Panelist, "Trend Setting Legal Decisions," The Lodging Conference, Phoenix (October 3, 2002).

Panelist, "Merger Mania," The Lodging Conference, Phoenix (September 13, 2001).

Panelist, "Law and The Management Agreement," The Lodging Conference, Phoenix (September 14, 2000).

Panelist, "Legal Developments Affecting the Hotel Industry: Franchising, Construction and Environmental Issues," The Lodging Conference, Phoenix (September 14, 2000).

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On September 28, 2005, USA Today published a full-page article in its business section entitled “*It’s a Hotel. It’s a Condo. No, It’s Both!*” Hoteliers and developers are not accustomed to seeing the lodging industry’s business trends make national news in the general press. The USA Today article clearly demonstrates that the condo hotel rage is in full swing.

The article also plants seeds of concern. It notes that officials in Hollywood Florida are reviewing hotel condominium projects totaling 2,500 units. With the exception of one traditional hotel application from Marriott, the article states, all the hotel-related applications before Hollywood officials are for hotel condominiums.

Why are so many hotel projects condo hotels? Are projects being pursued that should not be completed? If a borderline condo hotel is completed and sold out, how can its owners’ association or the developer (if he is still in the game) help avert an implosion?

1. What do we Mean by “Condo Hotels?”

A condo hotel is a hotel in which some or all of the guest rooms are sold to individuals under applicable condominium laws. Each unit owner then has the ability to rent the unit as part of the hotel’s operation.

The way a condo hotel is structured varies greatly, and developers are continuing to invent new configurations. In very general terms, there are primarily two different configurations. The main distinction between the two lies in who will end up owning and running the hotel’s revenue generating facilities, such as the front desk, the banquet and meeting space, and F&B outlets (these elements are commonly referred to as the “**commercial**” areas and operations). In the first configuration, the commercial areas are held and run by the condominium owners association for the benefit of the unit owners. In the second configuration (which is more prevalent in recently-developed condo hotels), the developer retains ownership of the commercial areas and thereby runs the commercial operation for the developer’s own benefit. In either event, the unit owners usually rent their units under a “rental program” agreement with the owners association or the developer (whichever owns and runs the commercial operation) or with the independent hotel manager, if one has been appointed.

2. Why Are So Many Current Hotel Projects Condo Hotels?

The traditional hotel developer seeking to build a hotel would typically proceed as follows:

- Obtain the site and entitlements
- Build the hotel
- Stabilize the hotel operation
- Sell the hotel

The stabilization process alone normally takes between two and four years. This means that a traditional hotel developer normally faces many years of work before a return on capital is expected.

In contrast, a condo hotel developer expects to sell some or all of the guest rooms to individual unit owners upon the completion of the hotel. In essence, the condo hotel developer is able to realize a sale of much of the hotel several years earlier than the developer of a traditional hotel. Also, construction loans for condominiums are often cheaper and easier to obtain than hotel construction loans—the developer benefits from these differences, as well. And if the condo hotel is managed by a major branded manager, the units typically sell for a premium over other condominiums. In short, the condo hotel developer expects (and has been achieving) higher rates of return than those achievable by traditional hotel development.

These and other benefits have driven the condo hotel rage so that, today, many (and in some segments most) of the hotels under development are planned as condo hotels.

3. Are Condo Hotel Projects Being Pursued That Should Not Be Completed?

If a project can yield a higher return as a condo hotel instead of a traditional hotel, will the developer choose to make it a condo hotel? Obviously, one would think that the answer is yes, and that does not necessarily cause concern. However, what if a hotel would not produce an acceptable return as a traditional hotel, and the only way it does pencil is if the project is developed as a condo hotel—is there then cause for concern?

To answer this question, one must first ask about investor expectations. A traditional hotel investor expects a significant yield on capital investment, typically at least a 12% IRR, to compensate the investor for the risk and long delay before a return can be captured. An individual condo unit buyer, however, likely has much lower expectations. If the unit is in a resort, the unit buyer would typically want to use the unit for 3 to 12 weeks a year. For the rest of the year, the unit owner may be quite content with rental income that allows the owner to break even on expenses and contribute some amount to the monthly mortgage payments.

Another way to look at the unit owner's investment expectation is to ask what a condo unit owner typically achieves when the unit is in a traditional, non-hotel condominium resort development. There, typically, a unit owner would pay a fee to a third-party service to rent the room by the week and arrange for cleaning expenses and upkeep. So if the net return to a unit

owner in a condo hotel is expected to equal or exceed the net return for a comparable, traditional condo unit in the vicinity, then a broad-brush analysis suggests that the unit owner's expectations are likely to be met.

Because these return expectations for condo unit owners may be well below the expectations for a hotel developer, one can further conclude that 1) many condo hotels are being built that could not be built as hotels, and 2) many of these should, in fact, be built if they are meeting or exceeding the expectations of the condo unit owners.

But at some point, even the lowered expectations of condo unit owners might not be met. What is this point? Most would agree that this point is clearly reached when the revenues from the hotel's commercial operation does not even cover the expenses of the operation. At that point, the unit owners likely will receive no return on the rental of their units. Certainly, one would then expect to have many angry unit owners. Short of that, if the net return to a unit owner is well below what owners of traditional condominium units in the vicinity are receiving for simple, weekly rentals, then one would also expect to have at least some angry unit owners.

If a condo hotel developer's projections show that the net income to unit owners is unlikely to meet these reasonable investment expectations, then the developer should question whether the hotel should be built. This questioning process might put the developer to the test. Sales projections might show that the units will sell out quickly and for a nice profit. This is a powerful motivator that can lead the developer to ignore the unit owners' reasonable expectations. Industry observers believe that, as a result, many condo hotel projects that should be declined are currently being considered and pursued.

4. If a Borderline Condo Hotel Is Built, How Can Its Owners' Association Or The Developer Help Avert A Litigation Implosion?

The developer should recognize that, if a development is inevitably going to produce angry unit owners, the short-term profit is likely to be eaten up quickly by later litigation. As we have written in other articles, condo hotel unit sales must be carefully structured and conducted to minimize the unit buyer's argument that the sale constituted a sale of a "security" under the securities law.¹ Even if a developer does its best to avoid the securities minefield, the risk cannot be avoided entirely. The reason is that there is always pressure on the sales people to make sales. Buyers typically do, in fact, want to hear about projections. But the securities laws clearly state that projections cannot be given without registration (a costly and ultimately unworkable process for most, if not all condo hotel developments). Shopping services show that, to make a sale, sales people often do cross the line and make oral statements and forecasts that constitute

¹ See "Condominium-Hotel Development: Beware the Securities Law Minefield," http://www.grahamdunn.com/WHATSNEW/ARTICLES/cybergrahams/beb_june2005.asp; see also the associated article, "The Condo-Hotel: When Might the Securities Laws Apply?" accessible under the same link.

securities violations. And even if the sales person does not do so, an angry buyer who is getting a very poor return could well “remember” oral statements to support a securities law claim.

A satisfied owner typically does not sue to get out of the deal. In contrast, owners who are angry and regret their investment are likely to find a way to sue for rescission under the securities laws. That remedy, if successful, would be very costly to the condo hotel developer. Even if the suit fails, the defense costs alone could well equal or exceed the developer’s profit. Obviously, then, the best way to avoid a condo hotel litigation “implosion” is to pursue only well-conceived projects that have strong prospects of meeting the reasonable expectations of all stakeholders, including unit owners.

As stated earlier, however, most people in the hotel industry have a strong sense that many condo hotel projects currently being pursued are likely to fail to meet owner expectations. Assuming that the train cannot be stopped and that questionable projects will in fact be completed and sold out, what then? Some projects, possibly, are so ill-conceived that the path to implosion is inevitable. But it is very likely that many projects only have an uncertain future—time will tell if they will meet owner expectations or ultimately implode.

It is safe to say that, if a completed condo hotel project implodes in litigation, there will be some nominal winners and losers, but every constituent will likely be a real loser in waste of time, expenses, and emotional aggravation. Implosions are to be avoided. For the “borderline” case, there are things that can be done avert an implosion.

As indicated at the beginning of this article, completed condo hotel projects often end up in one of two configurations. In the first configuration, all of the hotel’s commercial areas are turned over to and run by the condominium homeowners’ association (HOA). In the second configuration (which is found in many of the more recently-developed condo hotels), the developer retains ownership of and runs the commercial areas. In each case, the suggestions for avoiding a litigation implosion are similar.

a. First Configuration: When the HOA Is In Charge of the Hotel’s Commercial Operation.

When the hotel’s commercial areas are turned over to the HOA, the HOA becomes, in essence, a hotelier. The HOA may not be initially equipped to take on this challenge. Because of the HOA’s duties under applicable law, the HOA must rise to the challenge. What are the HOA’s duties? And how can the HOA satisfy them?

(1) The Duties Imposed Upon a Homeowners’ Association.

Because hotel condominiums are a relatively new phenomenon, there are currently no published cases that directly address an HOA’s management of a hotel’s commercial operation. The statutory and case law governing HOAs generally, however, gives a well-developed framework within which to analyze an HOA’s duties in the management of a hotel operation.

The HOA's duties in any condominium development flow from the duties imposed by state statutes, the Uniform Condominium Act, case law, the development's Declaration of Covenants, Conditions and Restrictions (**CC&Rs**), and the HOAs articles and bylaws.

The Uniform Condominium Act, adopted verbatim in a number of states, outlines a broad range of powers for the HOA, including the power to adopt budgets for revenues and expenditures, assess unit owners, hire and terminate managers, institute litigation, and repair and modify

common areas. *See* Uniform Condominium Act (the **Act**), § 3-102(A) (drafted 1980). The Act also sets out duties of the HOA. For example, the act states that the HOA generally "is responsible for maintenance, repair, and replacement of the common elements."

The Act further imposes duties on the members HOA's executive board. Under the Act, the executive board is a fiduciary to the unit owners if the members are appointed by the developer. *The Act*, § 3-107(A). Even after the board members are elected by the unit owners, the members must exercise "ordinary and reasonable care."

Beyond the duties imposed by the particular state's statutes, the CC&Rs and bylaws also typically impose duties on the HOA and its board members. The CC&Rs and bylaws are unique to the particular condominium development and are recorded so as to bind current and future condominium unit owners. Thus, when determining a particular HOA's duties, one must look not only to relevant law, but also to the CC&Rs and the bylaws.

(2) Examples of Suits Against HOAs for Failure to Perform Duties.

If an HOA fails to perform its duties, a plaintiff can sue the HOA for negligence, bring a cause of action against the HOA for breach of contract, or bring an action against the HOA's board of directors or officers for breach of fiduciary duty or the applicable standard of care.

The courts have considered suits against HOAs in the context of the HOA's alleged failure to keep up common areas. Some courts have determined that a unit owner has standing to sue the condominium association alleging tort or contract liability with respect to these duties. *See King's Grant Condominium v. Lloyd*, 614 A.2d 261 (Pa. 1992) (regarding condominium unit owner who brought negligence action against condominium association for damages caused by sewer backup in her unit).

In *Arias v. Katella Townhouse Homeowners Association, Inc.*, 127 Cal.App.4th 847 (2005), a unit owner sued her association for negligence, breach of contract, and declaratory relief for failure to maintain common areas causing toxic mold to develop. The California Court of Appeals agreed that the jury verdict of \$6,400 combined with the association's voluntary payments of \$88,939 made after expiration of the association's offer of \$50,001 made the unit owner the prevailing party, thus the unit owner could recover attorneys' fees and costs (both by CC&R and by California statute). *Arias*, 127 Cal.App.4th at 852.

Courts have held that a condominium HOA has a landlord's standard of care as to the common areas under its control. *See Frances T. v. Village Green Owners Ass'n*, 42 Cal.3d 490, 499-500,

229 Cal.Rptr. 456 (1986) (regarding HOA's failure to maintain proper lighting on the exterior of plaintiff's unit).

In *Schoondyke v. Heil, Heil, Smart & Golee, Inc.*, 411 N.E.2d 1168, 1170 (Ill. App. 1980), a non-owner occupier (the daughter of the owners) of a condominium unit brought an action against the HOA for injuries sustained in fall on snow-covered common area. The Illinois Appellate Court focused in on the fact that in the Declaration of Condominium and Condominium By-Laws, the association had "assumed a duty to remove natural accumulations of snow and ice." 411 N.E.2d at 1172.

The courts have also permitted unit owners to bring suit against HOAs and board members for their erroneous calculation of assessments as well for as other decisions by the HOA and board members. See *Owners of the Manor Homes of Whittingham v. Whittingham Homeowners Association, Inc.*, 842 A.2d 853 (N.J. App. 2004) (unit owners sued association and members of board challenging method used to calculate maintenance assessments); see also *Aghili v. Banks*, 63 S.W.3d 812 (Tex. 14th Dist. 2002) (unit owners sued association, management company, buyer, and attorney who conducted foreclosure sale, seeking to set aside the non-judicial foreclosure of their units).

(3) How HOAs Can Satisfy Their Duties When They Are Charged with Running a "Borderline" Condo Hotel.

If the HOA is responsible for the hotel's commercial elements, then the HOA's job is much more complex than the job required for the average condominium. Unlike a typical condominium, where the HOA might be charged with repairing dings in the common areas' drywall, the HOA is actually charged with running a very complex business—a hotel.

Applying the general concepts and case-law examples set forth above, it highly likely that applicable statutes will impose on the HOA the obligation to exercise, at least, "ordinary and reasonable care" in operating the hotel. This duty will also likely be imposed by statute upon the members and officers of the HOA board. See *The Act*, § 3-107(A). The applicable CCRs and bylaws may impose additional duties as well. And if an HOA or its board members fail to run the hotel with "ordinary and reasonable care," then a unit owner will likely be able to sue them for negligence or breach of contract.

The HOA and its board members must therefore ask, what is "ordinary and reasonable care" when it comes to operating a hotel? The question is not important simply to avoid liability. The question is perhaps more important to make sure the HOA is getting the best out of the operation for the benefit of all unit owners. This is particularly true when the condo hotel is a "borderline project" as described earlier in this article.

To answer the question, the HOA should look to standard practices in the hotel industry. The hotel industry is a mature industry, and extensive best practices have been developed in all aspects of the business. A simple illustration of refinement of hotel practices is the well-known fact that highly-regarded universities, such as Cornell University, offer four-year degrees in all aspects of hotel management. In short, the HOA of a condo hotel must become as familiar with

hotel practices and industry know-how as the average owner of a similar hotel in today's hospitality industry.

For example, if the hotel is an upscale or luxury product, with significant banquet space for business meetings, the HOA must aim at the highest and best use of these characteristics of the asset. This analysis should include consideration of a brand for the hotel's commercial operation. And when the opportunity to replace the hotel's management arises, the HOA should measure variables between branded, unbranded, and third-party management options, seek out appropriate brands, branded managers, and independent management companies, and request them to bid. The HOA should then negotiate the contract with skill and knowledge of an experienced hotel owner.

As another example, when a branded manager has been put under contract to manage the hotel, the HOA must ask how a prudent hotel owner would go about overseeing the branded manager in the exercise of its duties under the management contract. The annual budgeting process for a branded hotel is a well-developed dance. Often, the interests of the branded manager and the owner are not directly aligned in this process—the branded manager may want to add to the equity of its brand, while the owner might want to focus primarily on the owner's return. The same dance continues when the branded manager performs under the budget and the owner oversees that performance—the branded manager may want to focus on higher levels of service while the owner might focus more on cost-effectiveness and the kind of value that improves revenue. If the HOA board has highly experienced hoteliers and people that comparable hotels, then the board may be up to the task. If not, then the board may not be getting the performance it should and may be exposed to liability.

The board, in the exercise of "ordinary and reasonable care" should assess its expertise with cold objectivity. If adequate expertise is not held by the HOA's board or its officers, then the board should consider what similarly-situated hotel owners do under similar circumstances. Over the last decade, the hospitality industry has seen significant growth in companies that serve as "asset managers." These companies take on the responsibility of overseeing branded managers and getting the most out of their performance. Proponents of this industry trend refer to these firms as "guardian angels" watching over the owner's investment. Pension funds that own hotel assets and are not themselves hoteliers, for example, very often engage asset managers to fill the gaps in their knowledge and improve hotel performance. If the condo hotel is a similar asset, then the exercise of ordinary and reasonable care may well call for the engagement of an asset manager. More importantly, doing so could avoid the implosion of a borderline condo hotel operation, for the benefit of all unit owners.

b. Second Configuration: When the Developer Is In Charge of the Hotel's Commercial Operation.

The newer condo hotels frequently are configured in a seemingly unusual way. The developer sells all of the guest rooms to individual unit owners, but the developer retains, often as a separate condominium, all of the hotel's commercial areas. Thus the developer "stays in the game" and runs the commercial operation. Typically, this means that the developer offers the

rental program contract to the individual owners. Also, the developer is usually the party to the branded management contract.

There are several reasons why the developers are configuring the condo hotel this way. One reason is what might be called a “chicken and egg” problem with the branded manager. Frequently, the applicable State’s condominium laws allow an HOA to reject any contract made by the developer before the HOA assumes control of the hotel. For example, Florida Statutes §718.302(1) states:

Any...contract made by an association prior to assumption of control of the association by unit owners other than the developer, that provides for...management of...property serving the unit owners of a condominium shall be fair and reasonable, and such...contract may be canceled by unit owners other than the developer.

Branded management companies are very wary of these kinds of statutes. Branded managers bring a lot to the table. In upscale projects, a contract with a highly-regarded brand is known to increase the units’ selling prices by as much as 30%. Branded managers typically make this contribution in exchange for a long-term management contract. They do not like the idea that the HOA can cancel the contract after the units are sold and the HOA assumes control.

Also, many branded managers are concerned about the prospect of managing for HOA’s, which some believe are always difficult to deal with.

A developer often cannot attract a branded manager without addressing these concerns. And the developer may have a hard time financing or selling the units without attracting and signing a branded manager. For these reasons, and others, branded managers often push the developer to retain the commercial areas and serve as the party to the branded manager’s contract. The branded managers often also require the developer to back the hotel’s commercial operation financially, so that the branded manager feels it is protected in a downturn.

In other circumstances, a branded manager might not be involved, but the developer may just like the idea of retaining the revenue stream from the hotel’s commercial areas. Some developers even have a strategy to develop a brand by building condo hotels and holding onto management and ownership of the commercial elements.

When the hotel in any way approaches a “borderline” hotel, the developer must make sure that the seemingly-attractive revenue prospects are not outweighed by liability risks. As indicated earlier in this article, a project that does not meet the reasonable expectations of the unit owners is likely to implode. Owners who are angry and regret their investment are likely to find a way to sue. If the developer is right there on the property, managing the very operation that is failing, is there any doubt who will be the first target in this litigation?

A developer that retains the hotel’s commercial operation does not have the “reasonable and prudent” duties imposed on HOAs by the condominium laws. This doesn’t mean however, that the developer should not seek to meet or exceed those duties in its operation of the hotel. Because the developer is such an easy target, the developer is well advised to do everything in its

power to meet the short-term and long-term expectations of the unit owners. Like HOAs charged with running a hotel's commercial operation, the developer should assess its operational skills with cold objectivity. If a branded manager is under contract and the developer is not a seasoned hotelier, the developer should consider carefully the employment of the hospitality industry's best practices, including the engagement of a qualified asset manager as appropriate to make sure the operation runs as best as possible. This level of care will go far to avoid an implosion and, if one occurs, cannot help but improve the developer's chances in the ensuing litigation.

5. Conclusion.

The rewards of condo hotels in the current market environment are hard to resist. As a result, projects that are unsupportable or that are borderline are going forward. Given the risk of litigation implosion, developers should carefully consider all of the long-term risks, as well as the rewards. And if a borderline project is completed, the stakeholders, whether the HOA or the developer, must employ best practices of the industry. In an implosion, no one will be pleased with the outcome.