

## **Components and Key Agreements of a Mixed-Use Hotel-Residential Resort Project**

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In the hotel and resort development industry, the preferred development model is the “mixed use hotel project” that may also include a “condo hotel” component. This format can be employed in the downtown environment in a vertical tower that has retail space, offices, a hotel and, typically on the highest floors, luxury residential condominium apartments or suites. The development model works particularly well “on the beach” where the mixed-use hotel-residential resort project may also include resort amenities such as a marina, tennis courts and a golf course, and will always include a world class “signature” spa and health club. A commercial “village” may also be included.

This format has been employed in recent years for the development of Ritz-Carlton, Marriott, Mandarin-Oriental, Fairmont, St. Regis, Westin, Hyatt and other luxury branded resorts, where the developer enters into a complex set of agreements with a major branded hotel company to manage and license its names and know-how to the resort, including the residential products.

The advantages for the developer: 1) the real estate sales are a source of funding that can replace all or a substantial portion of the construction loan that would be required to develop the entire project as a hotel, 2) the hotel services and other resort amenities can be made available to occupants of the residences who are somewhat of a captive market, 3) affiliation with the hotel and its luxury brand will add significant uplift to the price at which the residences can be sold and 4) professional management from the hotel company is available to manage the entire project – i.e., the hotel and its amenities, the residential home owners associations and all of the common elements of the master project.

When financing a mixed-use resort, the senior lender to the project may require a “cash sweep” of at least a portion of the proceeds from sales of residential units in exchange for releasing its lien over the land under the sold residential unit. Over time, as residences are sold, the developer may be left with a hotel that has little or no debt financing.

In rural areas, such as vacant stretches of Caribbean beaches, where a branded resort is developed, land surrounding the branded resort that is outside the gates of the branded resort community will typically benefit from a “halo effect” and may also be a source of appreciated value to a developer who owns or controls adjacent land in addition to the land within the branded resort.

A “condo-hotel” exists where separately sold condominium units constitute all or part of the hotel’s inventory of available “keys”. One condominium unit may result in one, two, or more hotel keys when the owner is not in occupancy, depending upon the number of bedrooms in the unit that can be separately “locked off” (i.e., separately let out to hotel guests as self-contained hotel rooms). Rental of the condominium unit as a hotel room or as several hotel rooms is achieved by the unit owner’s entering into a “rental agreement” with the hotel or its management company whereby the unit owner agrees to make the unit available to the hotel when the owner chooses not to occupy the unit. A rental program might provide that the unit owner is limited to six weeks occupancy at specified times, and the other 46 weeks the unit is available as a hotel suite or hotel rooms. The revenue from the rental of the unit is shared with the unit owner after payment to the hotel of a rental commission, with the hotel typically receiving the lion’s share – as much as 65% of the rental revenue. To be eligible to participate in the rental program, the unit owner must buy an interior furnishings package from among a selection of a few such packages made available by the developer and set aside a reserve that will be collected by the hotel for replacement of interior furnishings as they become worn or outdated. This reserve is usually separate from and in addition to the reserve collected by the home owners association for replacement of common area components. The unit owner must also allow the hotel staff to provide housekeeping and maintenance services when the “hotel guest” is occupying the unit. The hotel guest will also have the full array of hotel services and amenities available and will not know or care that she is occupying a separately owned condominium unit or part thereof.

The legal pitfalls attendant to the sale of condo-hotel units, particularly securities law concerns arising from the possible characterization of the sale of the condo-hotel units as the sale of securities, have given rise to litigation and have caused the condo-hotel format to fall out of favor in the past two-three years. Recent mixed-use projects have been announced that do not contain a condo-hotel component. In sum, the developer is well advised not to offer the condo-hotel units as investment opportunities but as second or vacation homes that may be rented for the purpose of reducing carrying costs. As with all real estate sales, representations about income generation and appreciation must be avoided and other “safe harbor” rules must be adhered to.

The condominium units may be sold to purchasers who purchase a timeshare interval, perhaps only an undivided 1/50 interest – where the other 49 intervals are sold to other purchasers or some intervals may be retained by the hotel for use as “keys”.

The residential condominium units, whether or not they are available as hotel rooms, may be located entirely within the hotel structure as built as separate “townhouses” or other distinct structures that are not integrated into the hotel building.

Other branded residential components may also be free-standing individual homes which are sold to a single purchaser or as “fractionals” – e.g., in one-eighth undivided ownership interests. Typically, these homes are large and luxurious and are not included in a rental program – i.e., they are not used as hotel rooms when the owners are not present. In some projects, buying into a particular fractional home will give the purchaser access to other fractional homes in the project if another fractional owner of a particular home is occupying it during the same time period.

The mixed-use project may also consist of commercial units that are sold or leased to retailers whose presence presumably also adds to the appeal and value of the project, while providing additional cash flow in the form of rent or proceeds from the sale of the commercial space.

The project will be governed by a well-planned array of “covenants, conditions and restrictions” for the entire project and for each subcomponent to assure that the entire complex retains its quality and architectural integrity and to allocate the common charges, such as landscaping, common area maintenance, security and utilities, among each of the project components and, in turn, each unit owner and the hotel. Each residential component may have its own homeowners association as in the case of any condominium development. Naturally, the developer will seek to retain control of the various governing bodies as long as possible and to minimize the allocation of costs to the hotel where the developer retains ownership of the hotel.

The legal structure will depend upon the physical configuration of the improvements that make up the project. For example, common elements for the entire project may be owned by and managed through a master project association of which the hotel and each residential condominium, fractional or whole-ownership residence owner is a member, or the common elements may only exist within the residential condominium areas and therefore they may be owned by and managed through the condominium homeowners association, possibly with deed covenants, conditions and restrictions to protect the integrity of the entire project. Certain services, such as landscaping and maintenance, may be provided to the homeowners associations by the hotel for which the hotel will be compensated.

The legal structure of the project will also depend upon local law. For example, in certain Caribbean countries, a “strata corporation” will be used instead of the condominium format, each unit owner will own shares of the corporation to which a specific unit attaches, and the corporation will be governed by its board of directors rather than the homeowner’s association board. The agreements and other documentation required to accomplish the local legal structure will naturally be determined by local law and custom. Counsel representing the developer/owner in connection with the agreements with the hotel management company will have to

collaborate with good local counsel for the developer/owner to assure that such agreements are consistent with the agreements and other documents required under local law.

A large mixed-use project involves perhaps scores or hundreds of major agreements – including land acquisition agreements, joint venture agreements to secure equity financing, loan agreements and security documents for the typically multi-tiered loans, construction agreements and many, many more. The balance of this article will describe only those agreements required by the branded hotel management company.

To realize the anticipated appreciation in the value of the land offered for sale, whether as developed condominium units, time-shares, individual residences, or vacant land, the developer will select a hotel operator for the hotel component whose brand cache and management capability can be extended to the branded residential components and result in the highest unit sales prices and hotel room rates.

Branding and licensing of the hotel will be accomplished by a “hotel management agreement” or “hotel operating agreement” (the “HMA”) that will be essentially the same as the management agreements used for hotels that do not have accompanying branded residential components, except that the HMA will contain references to the other agreements described below, if only to create cross defaults among the various agreements.

Within the U.S., the HMA will typically provide that branding of the hotel is accomplished by the hotel management company’s having the right to designate the hotel by its brand name for so long as it is managing the hotel. By not having a separate license agreement or licensing provision within the management agreement, the management companies seem to be trying to avoid having the management agreement characterized as a franchise with the resultant obligation to comply with Federal and state franchise laws.

Outside the U.S., the brand typically will be provided to the hotel owner by means of a separate “license and royalty agreement” (“LRA”) to take advantage of tax provisions in the jurisdiction in which the hotel is located that may allow favorable tax treatment, such as exemption from tax withholding, where the license fee for use of the brand is viewed in the local jurisdiction as a royalty payment. Separating the management of the hotel from the brand license also may be employed to allow the hotel management company to use a local sole purpose management company, both for liability and tax reasons, while licensing the brand from the entity that owns the hotel management company’s worldwide trademark estate.

In addition, “central services” from the hotel management company, such as international marketing, reservations and employee training, may be provided pursuant to a separate “central services agreement” which, as in the case of the brand licensing provisions, may be embodied within the HMA for hotels in the U.S. or in a separate “central services agreement” or “international services agreement” (the “CSA”) outside the U.S.

The terms of the HMA, the LRA and the CSA that govern only the hotel component can be quite complex, particularly with respect to determination of the “incentive fee” in the HMA. The incentive fee is generally a percentage of some computation of “incentive income” that may be simply the hotel’s operating income (total revenue minus ordinary operating or departmental expenses) or may be some other number arrived at after the hotel’s property taxes, property insurance and debt service or an owner’s return on its investment are deducted. Payment of the incentive fee may be subordinated (and therefore postponed on either a recoverable or non-recoverable basis) to debt service or to some level of owner return on its investment. The terms of these agreements are beyond the scope of this article.

The hotel management company typically will provide “technical services” pursuant to a “technical services agreement” (“TSA”) which provides for design review services to assure that the project complies with the brand standards and operational requirements of the hotel management company. The hotel company will want to be sure that the project is sufficiently integrated so that hotel services and amenities can be available throughout the branded community to enhance the experience of all occupants and to assure that brand integrity is not compromised. There may be one TSA for the entire mixed-use hotel and residential resort project or separate TSAs – one for the hotel component and another for the residential component. As with the HMA, the terms of these agreements are beyond the scope of this article. However, a fixed amount plus reimbursement of “out of pocket” expenses is a typical fee formula.

The agreements to which the hotel management company will be a party that relate to the non-hotel components are usually the following:

-A “marketing and license agreement” (the “MLA”) pursuant to which the hotel management company will allow the developer to market for sale and brand the residential components with the hotel management company’s brand. An essential element of this agreement is the hotel management company’s control over the marketing materials and methods in order to assure brand standard compliance and avert liability for misrepresentations and other practices that may give rise to fraud claims on the part of the unit purchasers and to confirm that the units that are offered for sale are not sold in a manner that would cause them to be deemed to be “securities” under U.S. securities laws and regulations. Strong indemnification provisions whereby the developer indemnifies the hotel management company from all such claims and liability will be contained in these agreements with little room for negotiation on the part of the developer. The charge by the hotel management company for use of its brand in marketing the residential units is generally a percentage of the gross sales proceeds for the units in the 2%-4% range.

-A “condominium management agreement” (“CMA”) pursuant to which the hotel management company will manage the homeowner’s associations for the residential units in exchange for a fee that is typically based upon a percentage of the association’s approved annual operating budget.

- If there is a condo-hotel component, a “rental program agreement” (the “RMA”) pursuant to which the hotel management company or, as seems to be preferred by many hotel management companies, the hotel owning company, will provide to individual residential unit owners the option to participate in the hotel’s “rental program”. Under the rental program, unit owners permit the hotel or its management company to offer their units as hotel rooms available to hotel guests when the unit owners choose not to occupy them. Under these agreements, the rent proceeds are split between the unit owner and the hotel, with the latter receiving the lion’s share. In addition, the hotel management company may receive a rental commission for acting as rental agent for the unit owners.

Each mixed-use hotel hotel-residential resort project will inevitably require agreements that are unique to it, but the agreements described above will be utilized in most projects of this type that involve the major hotel management companies. Legal expertise in negotiating, drafting and integrating all of the many agreements is critical in to the success of the project.

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