March 7, 2006

Agreements for a Mixed Use Hotel-Residential Resort Project

By: Albert J. Pucciarelli
Chair, Hotels and Resorts Development Practice Group
McElroy, Deutsch, Mulvaney & Carpenter, L.L.P.

This article is the second of a two-part article on the subject of "mixed use hotel projects". The first article, Structure of a Mixed Use Hotel-Residential Resort Project, appeared in November, 2005, in HospitalityLawyer.com. As stated therein, the mixed-use hotel-residential resort project typically involves the combination of a branded hotel with a variety branded residential elements and resort amenities that may include a golf course, beach or harbor, and will always include a spa, health club and tennis courts.

In order 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.

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. 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 branding agreement" (the "MBA") 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.

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 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.

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. Naturally, the developer will seek to retain control n 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.

As noted in the prior article on this subject, the exact legal structure of the project will depend upon local law. For example, in certain Caribbean countries a "strata corporation" will be used instead of the condominium format, and 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 local counsel for the developer/owner to assure that such agreements are consistent with the agreements and other documents required under local law.

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.