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Components of a Mixed-Use Hotel-Residential Resort Project

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One need only consider the vast number of conference flyers advertising panel discussions of “mixed-use hotel projects” or “condo-hotel projects” to conclude that this format of development, with its apparent advantages to the developer, is very popular among hotel developers, particularly in resort settings.

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.

The branded residential components are typically condominium units that are sold to the public. The residential condominium component may be structured in any one of several variations.

In the case of a “condo hotel”, the condominium units constitute all or most 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” – that is separately let out to hotel guests as self-contained hotel rooms.

The condominium units may be distinct from the hotel structure as “townhouses” or other distinct structures that are not integrated into the hotel building, but are nevertheless available to the hotel as additional “keys” when the owner is not in occupancy.

The condominium units may be sold to purchasers who purchase a 100% undivided interest with unlimited occupancy rights, but voluntarily agree to make their unit available to the hotel when they choose not to occupy under a voluntary rental program. In this format, the hotel manager cannot be certain of the availability of condominium units when more “keys” are needed in periods of high demand.

The condominium units may be sold to purchasers who purchase a 100% undivided interest with limited occupancy rights – such as six weeks annually – with the unit reverting to hotel use during the remaining periods – 46 weeks in the example cited above.

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 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 used as hotel rooms when they are unoccupied by their owners. In some projects, buying into a particular home will give the purchaser access to other homes in the project if more than one fractional owner of a particular home want to occupy it during the same time period.

Where unit owner’s have occupancy rights, whether a full year or lesser interval, that they choose not to utilize, the unit owner may voluntarily allow the unit to be used as a hotel room under a voluntary rental program. These rental programs are voluntary to avoid the characterization of the investment in the condominium as a “security” under U.S. securities law (beyond the scope of this article) which, in turn, brings to bear a host of securities law and regulatory requirements and potential liability that developers strive to avoid.

Where units of any kind are to be made available as hotel rooms, the unit owners (or co-owners) must comply with the hotel brand standards for interior furnishings. This means that they must buy one 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 economic motivation to hotel developers who pursue the mixed-use hotel-residential resort format is generally twofold. First, the land surrounding the hotel, when included in the branded community in the “hallow” of the hotel generally will sell at a retail price, whether improved or not, well in excess of the wholesale price at which it was acquired by the developer and, where the developer has built the condominium units or homes, presumably in excess of the cost of construction incurred by the developer. The same “hallow effect” may benefit unbranded land owned by the developer outside but close to the branded project. Second, a very substantial benefit derives from the sale, especially the presale, of the residential components, because these sales provide the developer with cash proceeds early on in the development process that should exceed the developer’s costs by a significant amount and that can be used to reduce and in some cases eliminate the debt encumbering the project after completion. A senior lender to the project may even require a “cash sweep” of the proceeds from presales of residential units as its lien over the unit is released to free it for sale.

From the hotel operating perspective, a mixed-use hotel-residential resort project provides the hotel with available rooms as needed without the necessity of owning non-used hotel rooms during low occupancy periods and without having to bear the cost of FF&E upgrades for these rooms. As mentioned above, the unit owner bears the cost of keeping the unit in compliance with hotel band standards through the accumulation of an FF&E replacement reserve funded by the unit owner. The hotel

also benefits from the sale of hotel services to unit occupiers, whether the owner or the hotel guest is in occupancy.

The economic motivation for each unit owner is ownership of a vacation home with brand cache, availability (at a price) of hotel amenities, and the possibility of rental income during periods of non-occupancy. However, the rental split with the hotel when a unit is used as a hotel room is generally no better than 50-50, with additional charges for the rental commission and a reserve coming from the unit owner's share of the split.

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 unit.

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 in 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.

Each residential component may have its own homeowners association as in the case of any condominium development.

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 legal structure will also depend, of course, upon the physical configuration of the improvements that make up the project. For example, common elements serving the entire project may be owned by and managed through a master project association of which the hotel and each residential condominium 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.

The role of the hotel management company and brand licensor will be examined in a subsequent article on this topic.