



## Hotel-Condos: A Broken Promise?

*By Morris Newman*

Summertime in Las Vegas might be more scorching this year than usual due to the heat from a growing number of condo hotel lawsuits. A group of 40 investors who bought condo-hotel units — privately owned homes inside hotels that revert to hotel rooms when the owners are away — are suing the developers of Signature, a hotel and condominium complex developed by a partnership of MGM Mirage and Aventura, Fla.-based Turnberry Associates. The owners claim their units aren't generating the revenue promised by salesmen.

The basic facts are similar for a group of 12 buyers in Palm Beach County, Fla., who bought condo units at The Resort at Singer Island, developed by WCI Communities, based in Bonita Springs, Fla. They paid \$400,000 to \$2 million apiece for their units. Again, the expected rental income from the condo hotel never quite materialized. Some buyers, in fact, found themselves owing money to the very people who had sold them the condo units and who had promised, in essence, to be their business partners.

In both the Las Vegas and Palm Beach County cases, plaintiffs' lawyers are taking a similar tack: They are charging hotel owners for allegedly violating state and federal securities laws. If that is true, the lawyers argue, their clients were sold their units illegally, entitling the condo owners to undo the sales and get their money back, plus damages.

"The securities law in Florida is a 'blue-sky' law that is very broad and remedial," says Adam T. Rabin, an attorney for the Palm Beach County plaintiffs. A blue-sky statute is one designed to cover many kinds of violations, as opposed to a narrow set of circumstances. The state law, he adds, is "obviously quite forceful, to have the power to undo a bad investment and force full rescission."

The Florida case is still pending. The developer, WCI, did not return calls for comment. In Las Vegas, a District Court judge sent both sides to arbitration, and the plaintiffs are appealing the decision to the Nevada Supreme Court. Turnberry could not be reached for comment. Yvette Monet, a spokeswoman for MGM Mirage, says the hotel owners are "confident that we will prevail over the claims made by the plaintiffs."

### **Condo hotel financial magic**

Real estate lawyers and developers nationally are closely monitoring these cases. If the courts buy the lawyers' arguments — and some legal experts say those arguments are strong — a



decision against the developers may alter the condo-hotel model, or conceivably destroy it altogether.

One notable skeptic in the legal community is Rick Kirkbride, a partner in the Los Angeles office of law firm Paul Hastings. "The majority of the lawsuits that have been filed are mainly from buyers who want to get out of their purchase contracts," he says.

Those buyers, says Kirkbride, entered into contracts when the market was hot. "Now the market has declined and they want to get their deposits back." Adds Monet of Mirage: "Unfortunately, it seems that some real estate speculators made their own assumptions, which were unrealistic."

The condo-hotel business model has been around for 30 years and has been used with success at several high-end resorts, including the Hotel Del Coronado on Coronado Island, Calif., Deer Valley in Aspen, Colo., and in Hilton Head, N.C.

"Although condo hotels have worked well for decades," says Bruce Baltin, senior vice president with PKF Consulting's Los Angeles office, "there has been a kind of frenzy for them in the past several years, and not all developers have had the right fundamentals for them." Those fundamentals might include discipline by developers and sales agents not to promise returns on revenue buyers may receive when condos moonlight as rentals.

### **Flawed model**

One of the sharpest critics of condo-hotel flurry is Wayne Klein, a lodging-industry expert in the forensic accounting firm Lewis B. Freeman, a Miami-based consulting firm that advises lawyers on lawsuits and regulatory issues. He says the rapid rise of hybrid units has been fed by the hunger for instant riches.

"There's a saying that you can tell a crash is going to come when people start selling products that are very unusual and perhaps even incredible," says Klein, who formerly served as director of the State of Utah Division of Securities. "The boom in hotel condos is a sign of market excess."

The condo-motel is flawed, he argues, because the same entity that sold the condo to the investor is competing with the investor for hotel revenues. The hotelier customarily receives 100% of net income from its own rooms, while condo units offer only 50% of that amount, with the remainder going to the condo owner.

That arrangement can lead to a perception on the part of condo owners that the hotel owner is

giving preference to its units rather than those of the condo owner, according to Klein. In condo hotels, he says, "your fiduciary is also your competitor."

Some hotel developers argue, however, that they have systems to "randomize" the rooms offered to hotel guests, so condos owned by outsiders will be rented out as often as non-condo hotel rooms.

### **The thin line of the law**

Condo hotels hold plenty of appeal for developers because the condo-hotel business model is a proven way of attracting equity to projects that are hard to finance. Lenders typically ask borrowers to contribute 50% equity on a construction loan for a large hotel.

By selling a portion of hotel rooms as condominiums, some lenders can lower their loan-to-value ratios to 10% to 20%, because they can be assured of a hunk of cash on the day the hotel opens its doors. With a much reduced debt burden, the theory is that developers can reach profitability in a much shorter period of time.

Despite litigation in some areas, the condo-hotel financing model remains widely popular, although that may soon change. Hotels that include some condo units will account for nearly 7% of all hotel rooms under development, scheduled to start construction, or in the planning stages this year, according to Lodging Econometrics, an international hospitality consultant in Portsmouth, N.H. In 2009, however, the percentage of hybrid rooms will fall sharply to 4% of the total.

### **Weak market, bad press**

The anticipated drop in hotel condos is due to the weak housing market, as well as what Patrick Ford, president of Lodging Econometrics, calls the "deterioration of their reputation as vacation vehicles." Problem properties, he says, have gotten a lot of bad press. The drubbing that hotel condos have taken, he adds, is not dissimilar to the shellacking that time-shares took a few years back.

But if many condo buyers feel disillusioned and want their money back, will the securities-violation gambit win in court? Ford predicts "in some cases, the courts will probably adjudicate that some sales agents have crossed that line, and in other cases not."

Kirkbride admits "it's very easy for sales people who are not well-managed to get carried away."



He says he has seen only one blatant violation of securities law in 25 years of practice involving the sale of condo hotels units.

Disclosure of risk is a major principle underlying securities law, according to attorney Charles Thomas, who also represents the condo owners in the Singer Island Resort class-action suit. "If you go into a casino, you take that gamble knowing the risk. The casino owner can say, 'You gambled, you lost, go cry to somebody else,'" he says. In the case of securities, the Florida Securities and Investor Protection Act "wants people who buy securities to make an informed decision."

Most reputable developers disclaim any notion that condo hotels are moneymakers. MGM Mirage, for example, requires buyers to initial every page of sales contracts, including several with disclaimers. "While we were not privy to all of the conversations between the sales staff and prospective buyers," says Monet of MGM Mirage, "all of the buyers agreed to, in writing, repeated disclaimers contained in capital and bolded letters within the sales agreements."

### **Closing arguments**

Still, liability to securities-law violations may occur even if the developer does not make any claim about financial returns — at least in theory. By their very structure, hotel condo deals are innately securities, according to Rabin, the Florida plaintiffs' attorney.

Part of the definition of a security, he points out, is a common enterprise that employs a third party to act on the behalf of all the investors. In the case of condo hotels, the hotel operator, who books rooms and collects the fees on behalf of the owners, is the third party.

To support the notion that the condo is an investment and not a residence, Rabin states that the restricted amount of time that condo owners can spend in their units, as well as a prohibition on decorating and storage of personal belongings, makes the point that the unit is not a home first and foremost.

Kirkbride says he is unimpressed with the theory. Hotel condos, he says, are more correctly viewed as vacation amenities, like time-shares or fractionals, rather than second homes.

Opinions vary on the future of condo hotels, but Ford is pessimistic. The product, he says, will soon "be a blip on the screen of history." In contrast, Jim Butler, a partner at law firm Jeffers Mangels Butler & Marmaro in Los Angeles, notes that most lawsuits have involved smaller developers, not the institutional, branded hotel owners. There's a bell curve among condo-hotel operators, he says.



“If done correctly, the condo hotel can be a great product that works for the consumer and the developer alike,” Kirkbride says. “It's not for everyone.”

**Morris Newman is a Los Angeles writer.**

### **Condo hotels: business partner or competitor?**

For buyers, condo hotels might sound like a good proposition — at least on paper. A buyer purchases a unit at a hotel in a popular resort where he or she vacations a few weeks each year. For the rest of the time, the condo goes to work as a money-earning hotel room. The condo owner splits the income generated by the room with the hotel operator, after expenses, typically on a 50-50 basis.

With some luck, the buyer's condo-hotel room — often referred to as a “hybrid” unit — will end up paying for itself, and just possibly earn a little money. In the best cases, such as in projects with proven track records in popular resorts, it is conceivable that condo owners might earn as much as 10% annually on their units, according to Bruce Baltin, senior vice president with PKF Consulting's Los Angeles office.

The cost of entry is high, however, for the privilege of speculating on a resort condo. Units tend to be expensive, with developers citing the price of competing condos in the same market as comparables. The hotel owners also off-load additional costs to condo associations, such as common-area maintenance fees and a pro rata share of utility costs. Owners then must further pay a fee for third-party property management.

Despite the high fees, owners receive limited use of their units, often just a few months a year, of which only a few weeks fall within peak season. The hotel condo ownership contracts typically require owners to maintain the same standardized interiors and furniture as the regular hotel rooms. Similarly, owners are restricted from storing personal belongings in their units, beyond a small lock box.

Owners must also share the pool and athletic facilities with a transient crowd of strangers. These restrictions are sometimes cited by lawyers in lawsuits to argue that the condo hotel units are investments, rather than second homes.

Condo hotels are not so much housing as a “prepaid vacation,” says Pat Ford, president of Lodging Econometrics in Portsmouth, N.H. “You are essentially buying a vacation at a destination that you return to, and you are buying it inside a hotel operation that has all the services of a hotel, and gives you rights of use for a specified, contractual period of time.”



Buyers have a choice whether or not to contract with the host hotel to rent out the room when buyers are elsewhere. "In return," says Ford, "[the owners] get proceeds that will help offset the carrying cost and the debt service."

What then can the buyer expect, if anything, from the hotel condo as an investment? Best to expect nothing, according to Rick Kirkbride, a partner at law firm, Paul Hastings based in Los Angeles. "Any revenues you collect to offset your costs are gravy," he says. "You shouldn't buy a condo hotel if your expectations are more than that."

— **Morris Newman**