

The 5th Annual Hospitality Law Conference

February 8-9, 2007

International Condo Conversions

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John Vernon devotes his practice to domestic franchising law and international licensing, distribution and franchising law. He was recently named to the *Franchise Times*, prestigious “Best of the Best: Legal Eagles” list.

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International Condo Conversions

John M. Vernon, Esq.

The condominium hotel is the hottest venture in the hospitality world. In fact, the condo hotel concept has become so popular that many existing hotel operators are seriously considering moving their property from the traditional hotel model to the condo hotel model, in full or in part, or adding onto an existing hotel to house both traditional rooms and condominium rooms on property. The latest development in these condo projects is a combination of full time hotel rooms, condos that can be rented, and full time residence condos like the newly opened W Dallas Victory Hotel and Residences in downtown Dallas, TX. Whether a hotel owner sees it in their best interest to convert entirely or create some fraction of condo units within their remodeled hotel, all of the same basic principles apply. This paper will attempt to address the condo hotel conversion issue from many angles, including both business and legal aspects, both of which are key driving forces in the conversion process.

Why Condo Hotels?¹

One of the most common questions in the hospitality industry is also one of the most straightforward, basic questions: Why are so many people choosing the condo hotel model? The simple answer is the basic driving force behind all business: money. The simple fact is there is more money to be had from a condo hotel. First, the units are being sold. Pre-sales add equity to

¹ See articles such as: Hotel Online Special Report, *Catching the Buzz on Condo Hotels: A Roundtable Discussion*. Available at: http://www.hotel-online.com/News/PR2004_4th/Dec04_CondoHotelFrenzy.html; Jackson, Nancy Mann. *Going Condo*. PCMA Convene May 2006, p. 55; Stoler, Michael. *Hotel-to-Condo Conversions Spread Across City*, available at: http://www.firstamny.com/stoler_3_16_06.aspx; Webb, Steve. *Condos Help Seal Financing Deals*. Available at: http://www.nreionline.com/property/hotel/real_estate_condos_help_seal/; Hofmann, Michelle. *Finding Success in the Condo Craze*. Available at: <http://www.realtor.org/rmomag.NSF/pages/Feat2200602?OpenDocument>; Shinsato, Judith. *Renovation and Remodeling*. Available at: http://www.buildingindustryhawaii.com/deepfreeze/bi505/055_renovation.asp.

the project, and look good to lenders, which have become more and more reluctant to finance condo conversions for other types of properties (warehouses, offices, etc.)² This added equity can be used to back a loan to remodel the entire property or add on to the property, whether the eventual condo units comprise all or just some of the final plan. Second, the rental income will remain the same, if not increase, after the renovation. Ultimately, these condo units are still there to generate rental revenue. While a portion of this revenue is going to now be going to the unit's owner, a renovated hotel is likely to draw more guests. Moreover, the condo's owners are likely to visit more often, and therefore take advantage of some of the hotel's services, such as restaurants, which generates more income for the hotel. There may also be condo fees to the owner, for the maintenance of common areas, which increase income. Finally, there is a cost savings in that the condo owner is now responsible for property taxes rather than the hotel owner. While the hotel owner will still be responsible for some taxes, the amount should be far less than prior to the conversion.

The market for condo hotels with high class amenities is also booming. Travelers are increasingly interested in four and five star accommodations. They find the ability to own a vacation home appealing, but would rather have the ease of a condo which has a professional management company to handle rentals and any day to day issues. They also find the high quality and generally popular brand name appealing for their own travel needs. Finally, the branded hotels can bring in more guests, which means a greater rental income to offset costs of ownership. On the more advanced conversions, some full time residents find the location appealing, or the additional amenities that would add significant cost to a standard condo or

² Diana Mirel, *Property Managers Convert: as more property managers get involved in today's condo conversion craze, they reap rewards and face challenges never experienced before.* Available at <http://www.knowledgeplex.org/news/163077.html>

house a comparative bargain. These different types of condo units, rentals versus residents, attract different buyers, and need to be positioned and marketed accordingly. These different condo mixtures also need to have different management considerations.

Managing Condo Hotels³

A condo hotel in many ways runs just like a normal hotel, but in other ways does not. Much of the similarities or differences depend on the mix of units: full time hotel rooms, condo hotel rooms, and full time resident condos. While some of the basic elements are the same, such as selecting branding, many of the hotel or remaining unbranded, other elements depend on the mix of the units and the approach chosen by the owner of the hotel.

There are two primary different approaches to the condo hotel, and while most articles on the topic take one view or the other, practically none state which view they are taking or that there even is an alternate approach. The two approaches can be summarized: A condo complex with hotel elements or a hotel with units for sale. The origin of the condo hotel starts with the former, which has been done for years in parts of the Caribbean and Mexico. With those condo hotels, it was a collective of a few condo or bungalow type buildings who had an on site manager to handle the day to day maintenance while the owner remained in their home state. The key element here is that each unit was totally unique, decorated and furnished by the owner. What is becoming more common now is the second approach, especially with the luxury branded hotels. These hotels strive for uniformity in their offerings, and so while they may sell the unit, they will furnish it and maintain it. These two approaches also lend themselves to different management agreements and fee allocation. In the first approach, the owner would take a larger cut of the

³ See articles such as: Butler, Jim. *Condo Hotels: Who Owns What? Who Controls What? Who Pays for What?*. Global Hospitality Advisor, June 2006, p. 2. See Also Fn. 1.

profits, but it is because they are responsible for more things directly. The latter is going to have the hotel keep a larger cut of the profits, but that is because they are responsible for more.

There is also significant consideration needed for the management of the common areas. First, a manager needs to determine what, if any, distinctions are to be made between full time residents, part time residents, and hotel guests. Some distinctions may be simpler, for example keycard restricted areas for full time residents only or no linen service for full time residents. Others, such as pool towels, may need to be the same across classes for simple logistical purposes. Still other features, like charging things “to the room” may be optional for residents, such as tying the room to a credit card or a monthly tab in the same example. These are the kind of considerations that need to be fully addressed before the offerings are made to owners and before the hotel has any guests. By the same token, revenue generating common facilities, such as meeting rooms, restaurants, and even the gift shop need to have their profits relegated specifically. It is becoming more common that these go to the management company, but the older model had these revenues going, at least in part, to the owners as well as the management company.⁴ Property managers need to consider all of these issues as early as possible.

Property Law Issues

Property laws apply differently to condos than to typical hotel rooms. Just one such example is that in the US, for mortgage bankers to accept a room as a condo, a kitchenette is required, typically consisting of a microwave, refrigerator, and a sink at a minimum.⁵ These guidelines are set by Fannie Mae and Freddie Mac. Moreover, since these units are owned rather than rented, far more consideration

⁴ Sandman, Irvin R. and Kelly C. Aldrich. *How developers and Owners' Associations Can Avert A Hotel Implosion*. Fourth Annual Hospitality Law Conference, February 2-3, 2006.

⁵ Hotel-Online.com, *Individual Investors in Hotel/Condo Units Finding it a Formula for Making Money*. Available at http://www.hotel-online.com/News/PR2005_3rd/July05_CondosMyrtle.html

must be given to ownership by the occupant. This can cause potential problems with condo hotels abroad, as property laws vary from country to country. For illustration sake, I will give a few examples from around the world.

The Czech Republic has been a popular place for tourists and summers abroad for quite some time. Hence, the hospitality industry always does well, especially near Prague, and therefore condo hotel instances are likely to increase. While Czech law does allow for foreign owned land under certain circumstances, for example inheritance, most foreign citizens cannot own land.⁶ As such, the most common method for land ownership is using an entity called an SRO, which is basically an LLC.⁷ The process is relatively simple and straight forward, and it can help deal with Czech taxes and issues of local compliance. Property ownership is complicated, however, by the two different types of ownership recognized by Czech law: *osobní vlastnictví*, or OV, and *družstevní vlastnictví*, or DV.⁸ OV is private ownership as most are familiar with the concept. DV is a cooperative ownership of apartments or similar buildings which could be used in a condo hotel concept. However, it is practically impossible for a foreigner to own a unit in a DV setup when created by Czech entities, as the memorandum of association usually limits ownership as such.⁹ However, an international creator of a DV could conceivably set up a DV with no such limit. DVs also avoid individual tenant registries with the Land Ministry, which can delay purchases up to two months.

Bulgaria, while another Eastern European nation, has still different property laws. The Bulgarian Property Law was last amended July 2000, and has since left only one restriction on property ownership:

⁶ ExpatFocus.com, *Czech Republic – Buying Property*, available at <http://www.expatsfocus.com/expatriate-czech-republic-buying>

⁷ *Id.*

⁸ PropertyNewsDesk.com, *Investing In the Czech Republic - All You Need To Know About Ownership*, available at <http://propertynewsdesk.com/content/modules/news/article.php?storyid=54>

⁹ *Id.*

only Bulgarian citizens and corporations can own land in Bulgaria.¹⁰ Therefore, for the vast majority of clients, a Bulgarian corporation needs to be created to own the property. However, Bulgarian companies have no limits on the amount of foreign ownership they have, so the corporation is more of a formality.¹¹ Moreover, for companies interested in using the condo hotel model, foreigners are allowed to buy buildings, just not the land. Therefore, condo units could be sold without the need for a Bulgarian entity, making it a simpler, more appealing transaction.

Hungary allows foreigners to purchase one piece of property in the country, provided the foreigner gets approval from local officials and pays a fee. Many clients, however, will want to opt to have a Hungarian corporation because there is a tax break from 20% to 16% on the eventual sale of the property.¹² Other aspects of property research may require local counsel, but avoiding long term problems is well worth the expense. The diversity in Eastern Europe is equally prevalent in other regions such as Asia. For example, China has no restriction on foreign owned property. However, current laws allow the government to seize certain property for development, but pay far less than market value.¹³ It is essentially the Chinese equivalent to eminent domain, but the impact is far greater and the seizure is far simpler for the government with little recourse for the consumer. There have also been many reports of real estate related scams in recent years, so finding reputable local assistance should likely be a priority for anyone to the Chinese market.

Singapore, on the other hand, is an example of one of the more peculiar sets of rules for property ownership. Foreigners are restricted from buying property other than apartments in buildings six stories

¹⁰ PropertyNewsdesk.com, *Bulgaria: The Bulgarian Property Market – An Overview*, available at <http://propertynewsdesk.com/content/modules/news/article.php?storyid=81>

¹¹ ExpatFocus.com, *Bulgaria – Buying Property*, available at <http://www.expatsfocus.com/expatriate-bulgaria-buying-property>

¹² ExpatFocus.com, *Hungary – Buying Property*, available at <http://www.expatsfocus.com/expatriate-hungary-buying-property>

¹³ ExpatFocus.com, *China – Buying Property*, available at <http://www.expatsfocus.com/expatriate-china-buying-property>

or higher or approved condominium units.¹⁴ This poses two concerns for developers of condo hotels: acquiring permission from the local government to create the hotel and getting permission to sell the units to foreigners. Also of concern is Singapore's bi-annual property tax, which is due in advance and based on the rental value of the property.

Building in Thailand requires more capital than one would expect. Before even being eligible to buy property, you must invest \$1 million in the government for five years in order to own land as a foreigner.¹⁵ This is complicated by the fact that a mere Thai entity is not sufficient to skirt the rule, it must be owned in majority by Thai shareholders, both in number and capital. While the timeshare and condo hotel concept are becoming popular already, the legal grounds for these arrangements are not thoroughly solidified. For example, there is a restriction on the number of foreigners who can own units in a condo-type complex, specifically no more than 49%. However, how that applies to a time share, for example, is not entirely clear. Local counsel is a must in Thailand, especially on these emerging issues.

Securities Law Issues

Condo hotel owners have to tread carefully if they want to avoid the SEC. However, given the amount of control over the units desired by some luxury brands, following securities laws may be the only option, rather than trying to avoid them. There are essentially 3 instances where the securities laws will be triggered:

1. the condominium unit is offered in conjunction with any rental arrangement or similar service that emphasizes the economic benefits provided to the unit purchaser by the managerial efforts of the project owner/developer, or any third

¹⁴ ExpatFocus.com, *Singapore – Buying Property*, available at <http://www.expatsfocus.com/expatriate-singapore-buying-property>

¹⁵ ExpatFocus.com, *Thailand – Buying Property*, available at <http://www.expatsfocus.com/expatriate-thailand-buying-property>

party designated by the owner/developer, with respect to rental of the condominium units;

2. the condominium unit is offered in conjunction with a right to participate in a rental pooling arrangement; or
3. the condominium unit is offered in conjunction with a rental or similar arrangement pursuant to which the unit purchaser is required to hold the unit available for rental for some part of the year, must use an exclusive rental agent, or is otherwise materially restricted with respect to occupancy of the unit.¹⁶

This poses some complexity, if not impossibility, for the luxury brand who wishes to have absolute control over all the units in the building. The simple answer, of course, is to just comply with federal Securities Laws. The alternative is to take the creative way around the SEC rules, perhaps by putting requirements in the condo association agreement rather than in the offering. However, this is treading a fine line. The other complexity is that securities laws overseas may not match those in the US, so any international application of a system will require county by county research to ensure compliance with local laws.

Guidelines have been noted in other articles about condo hotels and securities issues, but they are limited to US restrictions.¹⁷ While these guidelines may serve as a starting place, research needs to be done case by case and country by country. As an example, here is a summary of a few guidelines. First, the sales group and the hotel management group must be

¹⁶ See Securities Act Rel. No. 5347, Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sales of Condominium Units in a Real Estate Development (January 4, 1973).

¹⁷ Ray, Randall G. *Securities Issues: Rental Programs for Condominium Hotel Units*. Fourth Annual Hospitality Law Conference, February 2-3, 2006.

kept entirely separate from one another.¹⁸ This means no common employees, common filing cabinets, common anything. Second, the management program offered by the hotel must be entirely voluntary.¹⁹ This lack of control may not be acceptable to some of the luxury hotel chains worldwide, and may be the sole factor for acquiescing to SEC guidelines. As a third and final example, the real estate personnel may not make any mention about the money to be made from renting the unit.²⁰ Rather this has to be positioned as a vacation home, not an investment with an annual return. There are other specific points, like rents must not be pooled, but overall, there are many, many guidelines to be aware of and be wary of in structuring condo hotel offerings in regard to SEC rules and securities laws. Of course, more issues beyond simple rent need to be analyzed as well, such as any revenue from shared areas, if distributed, and how that may impact securities laws, domestically or abroad. The condo hotel can be run in so many different ways that the case by case element of the analysis cannot be emphasized enough.

Conclusion

New developments in the hospitality industry inevitably lead to new challenges. Because of the unique nature of a condo hotel offering, there are challenges for both the developer, the manager, and counsel in determining how to make these systems operate in the way they want while avoiding running afoul of any laws and maintaining a client base for both the condo sales and the hotel occupancy. However, because of the versatility of the condo hotel system, every construction must be taken on a case by case basis. A new condo hotel casino development in Las Vegas is going to face different issues than a hotel and residence development in Dallas, and

¹⁸ *Id.* at 4.

¹⁹ *Id.* at 6.

²⁰ *Id.* at 5.

a condo hotel in China will be under different governmental restrictions than a condo hotel in Bulgaria. As such, no article could adequately address every concern for every potential project, and so even the most seasoned hospitality attorney needs to take these projects as they come, rather than hoping knowledge from past projects will more or less apply to the new one. Certainly, the prudent counsel will advise his client to take a similar approach in planning their condo hotel projects, so that they will not expect each to go as smoothly or smoother than the last. The condo hotel is here to stay, it seems, and so the future should bring additional clarity on existing regulations, or perhaps new regulations geared more specifically toward these unique offerings. But that may depend largely on the widespread success of the condo hotels being built or converted now.

5th Annual Hospitality Law Conference
Presents

A Course of Lodging Delicacies

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**John Vernon &
Hans Vogel**

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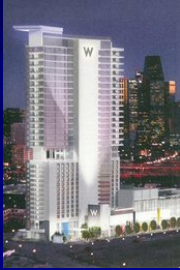


Hans Vogel

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- He studied law in Saarbrücken and Bonn and acquired a PhD Degree in international business law.
- He organizes international contacts and memberships of the company – among others – in the International Business Law Consortium and Interlegal.

Why Condo-Hotels?

Condo-hotels- One of the hottest ventures in the hospitality world



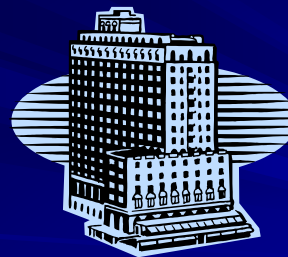
❖ Latest development- international expansion

- Models vary:
 - combination of full-time hotel rooms;
 - condos that can be rented; and
 - full time residence condos.
- Whether hotel owner desires to convert all or a fraction of the condo units within remodeled hotel- same basic principles apply.

MONEY



Why this demand?



- ❖ Units are being sold
 - Pre-sales add equity to project
 - Looks good to lenders who previously have been reluctant to loan
- ❖ Rental income will remain consistent
- ❖ Renovated hotel draws guests.
- ❖ Condo owners likely to take advantage of hotel related services (i.e. restaurants, spa, etc.)
- ❖ Condo fees for common maintenance, and savings of property taxes paid by condo-owner



- ❖ Americans are traveling more and more and are interested in foreign vacation homes to buy or rent
 - Want 4 to 5 star accommodations
 - Popular brands
 - Apply travel loyalty points
 - Foreign locations are appealing
 - Professional management companies handling day-to-day booking issues is appealing and convenient to condo-owners
 - Branded hotels bring in more guests to offset cost of ownership

First Approach



- ❖ Early Caribbean and Mexican resorts structured as condo complexes with hotel units.
- ❖ Collective of a few bungalow type condo buildings with an onsite manager handling operations.
- ❖ Owner visited frequently but lived elsewhere.
- ❖ Eclectically decorated to suit owners taste.
- ❖ Owner keeps larger cut of profits.

Managing Condo-Hotels



- ❖ Two Approaches:
 1. Condo complex with hotel units
 2. Hotel with units for sale

Second Approach



- ❖ Uniformity of offerings, similar design and furnishings.
- ❖ Hotel keeps larger cut of profits.
- ❖ Managers in both operations are responsible for common areas.
- ❖ What distinctions are to be made between full time residents, part time residents and hotel guests?



- ❖ Key card restrictions/security
- ❖ Linen service
- ❖ “To the Room Charges”
- ❖ Allocation of profits and expenses
- ❖ Spa, meeting rooms, restaurants, gift shops, etc.
- ❖ Condo homeowner associations

Czech Republic



- ❖ Popular tourist destination
- ❖ Condo-hotel developments are growing near Prague each year
- ❖ Difficult for foreigners to own land
- ❖ SRO similar to LLC most common vehicle for property ownership
- ❖ Process is relatively simple, but ownership can be complicated by other types of ownership
 - O.V. – Osobni Vlastnictvi (private ownership); and
 - D.V. – Druzstevni Vlastnictvi (cooperative ownership of apartments utilized for hotel/condo concepts)

Property Law Issues



- ❖ Property laws apply differently to condos than to hotel rooms, both domestically and internationally
- ❖ Property laws vary from country-to-country

Czech Republic



- ❖ Practically impossible for foreigner to own interests because of set out in the memorandum of association by-laws organized under Czech law without strategic drafting and local counsel
- ❖ D.V.'s avoid individual tenant registries with the Land Ministry which can delay purchases for months

China



- ❖ Few restriction on foreign owned property
- ❖ Current laws allow government to condemn property for development purposes and pay far less than market value

Thailand



- ❖ Prior to property purchase must invest \$1 Million in government for five years to own land as a foreigner
- ❖ Foreign owners can only invest in ownership vehicles that the majority of ownership is by Thai citizens
- ❖ Condo-hotels and time shares are very popular even without a relaxation of foreign investments laws

Singapore



- ❖ Foreigners are restricted from buying apartments in buildings six stories or higher or condo units
- ❖ Obstacles:
 - Acquiring permission from the local government to create the hotel and getting permission to sell to foreigners



- ❖ Too new for any definite conclusions
- ❖ Many challenges ahead for owner, manager, developer and counsel
- ❖ Each country must be analyzed on a case-by-case basis
- ❖ Condo-hotel future is bright, future will bring clarity to existing regulations
- ❖ Pending revisions to existing regulations in place currently from Turkey to Taiwan
- ❖ All depends on wide spread success of condo-hotels in global markets