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Fighting City Hall: Condo Hotel Ordinances

by Catherine DeBono Holmes

With the increasing demand for condo hotel building approvals around the country, municipal governments have scrambled to develop zoning ordinances that will allow high quality condo hotel developments, while at the same time (1) preserving the transient occupancy tax ("TOT") revenues that are so important to city finances, (2) assuring an adequate supply of transient hotel rooms for tourists, as well as business and leisure travelers (to support tourism, and municipal facilities such as convention and conference centers), and (3) controlling additional costs for and burdens on local infrastructure such as schools and city services.

Cities in hot markets like California, Florida, New York and Nevada have looked at examples from some of the early adopters of condo hotel zoning ordinances, and some cities have sought help from local attorneys aimed at further refining the requirements for approval of condo hotel developments.

Developers need to carefully review these detailed ordinance provisions, as they may, in some cases, be counterproductive to the sale and operation of a condo hotel. In addition, developers must be cautious about their own involvement in the adoption of municipal ordinances, or they run the risk of converting the offering of their condo hotel units into an offering of "securities" under federal securities law. (See *Condo Hotels: How to Make Them Work*, Jim Butler & Guy Maisnik, ***Urban Land,*** February 2005).

This dreaded event (converting real estate into securities) is a potential disaster for developers, and there are a number of dangerous traps for the unwary in the process of dealing with municipal ordinances concerning condo hotels that this article will cover.

Restrictions on Unit Owner May Jeopardize SEC Status

Overly restrictive use and rental conditions on condo-hotel unit owners in an ordinance could, under certain conditions, result in the condo hotel units being characterized as securities under federal and/or state securities laws. In the past, through a series of "no action" letters, the Securities and Exchange Commission (SEC) has provided comfort to developers that limited zoning restrictions, including prohibitions on use of a condo hotel unit as a permanent residence and requiring a unit owner to make the unit available for rental, will not automatically make the condo offering a "security."

However, developers need to be aware that the SEC's no action letters are not binding on the courts, and the SEC can change its position depending on the facts of each offering or upon changes in the SEC's views in general. So developers cannot rely on prior no action letters as a protection against any potential securities claims by regulators or purchasers.

The SEC has recently given informal advice that it will examine the totality of all restrictions and requirements on unit owners, including those imposed by zoning ordinances, in determining when condo units will be deemed securities. Therefore, developers should not assume that *any* restriction on unit owners contained in a zoning ordinance will automatically be acceptable to the SEC or other authorities in their determination whether the condo units are securities.

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Standards for Hotels and Hotel Operators May Be Unreasonable

One recent proposed ordinance would have required every condo hotel to be operated under a "brand" included in the "Upscale Segment" or "Luxury Segment" defined by J.D. Power and Associates, and, upon completion, to meet the published requirements to receive a rating of no less than a Mobil 4-star or AAA 4-diamond designation. While these designations may sound like a reasonable assurance that every approved condo hotel will meet the highest quality standards of operation, they may impose undue restrictions upon the developer and create unrealizable expectations.

Many condo hotel developers, as well as potential purchasers of condo hotels in future years, may desire to be owner-managed, rather than managed by a "brand. In addition, most hotels that are regarded as luxury hotels, and that are commonly spoken of as Mobil 4-star or 5-star hotels or AAA 4-diamond or 5-diamond hotels, are not in fact holders of the actual designation from Mobil or AAA. The higher luxury hotel ratings (e.g. 4- and 5-diamond or star ratings) involve some very subjective and elusive qualities, and even if a hotel achieves such a rating, the rating might be lost on technical grounds without a material reduction in quality. However, in either event, the developer's hotel could fail the test and be in violation of the municipal ordinance.

It is preferable that zoning requirements speak in terms of hotels being operated as "upscale" or "luxury" hotels, without specifying either that they are required to operated by a "brand" or that they maintain a particular Mobil or AAA ranking.

Common Area Ownership

One recent proposed ordinance required that the common areas of the condo hotel be owned by the developer or an entity other than the condo hotel unit owners. This was apparently designed to avoid having the homeowners association (or HOA) own the common areas of the hotel. However, the condominium regulations of some states require that common areas be owned by an HOA, or at least have the possibility of transfer to an HOA upon certain events.

In addition, some state laws do not allow cities to regulate who owns property, and require that ordinances be limited to restrictions on use of property. Therefore, an ordinance that regulates who owns common areas of a condo hotel could cause the condo hotel to violate provisions of state law and perhaps fail to receive approval for sale to purchasers in one or more states. Matters regarding the ownership of common area are best left to existing state laws and regulators.

Hotel Management Agreements

Another recent proposed ordinance required that a condo hotel HOA enter into a management agreement with a hotel manager for at least five years. However, the condominium regulations of some states limit the duration of contracts that may be entered into by an HOA. Therefore, this provision could be in conflict with state law. In addition, some hotel operators may not agree to enter into a management agreement with an HOA, although they might agree to a management agreement with the developer and the individual unit owners. The ordinance could therefore deny the developer the ability to enter into a management agreement with a desired hotel operator.

Budgets and Other Operating Matters

Some ordinances require the developer to submit budgets for the condo hotel HOA to maintain the hotel. Such an ordinance assumes that the HOA will be responsible for maintaining the hotel, but that is not the case in all circumstances. In fact, the standards for operation of condo hotels, including the budgeting process and other operational matters, are undergoing significant changes, as developers around the country experiment with various types of operational models. Cities should allow for this process and not micro-manage condo hotel operational matters.

Beware of Developer Participation in the Ordinance Process

Some developers understandably want to work closely with city building authorities to craft

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ordinances that the developers believe will provide necessary flexibility to the developer and solve certain hotel operating issues by limiting owner use and occupancy rights. But this can be very dangerous. Overly active participation by a developer in an ordinance process that results in restrictions on owners use and rental of their condo units could potentially risk converting the condominium offering into an offering of *securities*.

The SEC has said that limited restrictions on condo hotel owner use imposed by a *pre-existing ordinance* will not cause a project to be a security. However, if a developer uses the ordinance process to create material restrictions on an owner's use, it is possible that the SEC (or a court) could decide that owner use restrictions imposed by ordinance were in fact *caused by* the developer's own actions, and renders the condo offering a security.

In general, developers should limit their participation in the ordinance drafting process. Developers can probably work to *reduce* municipally imposed restrictions on developers and owners as to use and management of a condo hotel, but these issues normally should be brought to the attention of the municipality officials in a conceptual way, so as to improve their understanding of condo hotels rather than providing the city with drafts of the developer's desired ordinance provisions. In fact the entire interaction with the city in the ordinance process must be carefully guided to avoid running afoul of important SEC considerations.

Municipalities Should Regulate With Care

Municipalities have legitimate reasons to regulate condo hotels, but they must do so carefully or they will destroy the developer's incentives and ability to build condo hotels. Over-regulation strips value from the condo hotel real estate and makes it more difficult to justify the skyrocketing costs of construction. Undue restrictions can also deter unit purchasers from buying and present operational issues that discourage quality operators essential to a successful project.

Finally, overly restrictive municipal regulation of condo hotels could create insurmountable SEC problems for developers by causing the condo hotel units to become securities—either by overly burdensome restrictions on owner use and rental of condo units, or by drawing developers into too much involvement in the ordinance process. Either road leads to disaster and may convert the offering of condominium real estate into an offering of condominium securities.
Most importantly for cities, bad ordinances with unnecessary and ill-conceived restrictions will discourage good projects that would otherwise benefit the cities, the developers, residential unit buyers and the traveling public.

About the Author

Catherine DeBono Holmes is a senior member of JMBM's Global Hospitality Group and a partner in the firm's Corporate Department. Catherine assists clients with hotel management and franchise agreements, purchase and sale transactions, and condo hotel regime structuring. For example, Catherine provides national representation for a large hotel owner's hotel management and franchise agreements. She recently assisted a client with a 1,500+ room convention hotel in successfully concluding a complex RFP process involving all the major hotel brands and negotiating a favorable management agreement. She devotes a significant part of her practice to advising condo hotel clients on many important business and legal aspects condo hotel regime structure and condo hotel documentation, including CC&Rs, HOA docs, unit management agreements, shared facilities agreements, rental management agreement programs, and securities compliance matters (structuring, documentation and training). Catherine can be reached at 310.201.3553 or cholmes@jmbm.com.