

## **Hotel Online Special Report**

The Global Hospitality Advisor

The "Condo" Part of Condo Hotels

A Primer on How to Create a "Common Interest Development"

By David Waite

The recent success of projects where condominiums have been married with a hotel component has created a new development (and redevelopment) model for both condo and hotel projects. It is also one offering great profit potential for developers of condos and hotels alike. While condo developers need to learn a great deal about hotels in order to be successful with this model, the same is true of hotel developers learning about condos. Many hotel executives have never been exposed to the process for creating condos.

If it Feels Like a Hotel, What Makes it a Condo?

Although the project might look and feel like a hotel, by definition, at least some portion of the condo units are owned by private unit owners but are used by the hotel for hotel guests. The hotel operator is usually the steward for property management, creating enhanced values by providing premium services, amenities, design, rental programs, and brand recognition for branded properties.

The condo hotel typically utilizes the well-recognized condominium form of real estate ownership, which creates "undivided" common interests in some portion of the land and the improvements upon which the project is located, coupled with a separate interest in a condominium "airspace." Importantly for the condo hotel developer, each separate legal condominium unit or parcel, once created, can be sold to the public as a separate legal parcel of real property.

The condo units (legally defined as nothing more than "air space" within the physical confines of a habitable dwelling unit) need not be attached to the land, except by easements for access and support. For example, a unit on the second floor is not attached to the land. It is "air space" within the building, accessed by stairs or an elevator.

From a legal standpoint, the two key attributes of a condominium are: (1) the ownership by an individual of a separate interest in a discernable space (a condominium unit), and (2) the ownership of a proportional but undivided interest in the common area. The "common area," owned and operated by condo owners as a "common interest development," is where the hotel operator usually comes into play.

At least some portion of the "common area" in a condominium project must be owned by the unit owners as undivided interests or "tenants in common." Typically, the condo owners also like to transfer to their homeowners association (or HOA) common areas requiring regular maintenance and upkeep, as well as those areas most likely to incur liability. In a condo hotel transaction, the hotel operator might agree to manage the HOA, all or a portion of the "common area," and certainly the hotel component of the project. In a condo hotel transaction, the extent of what is defined as "common area" can vary

significantly from project to project. For example, while the hallways leading to condo units might be included in the common area, the hotel meeting rooms, pool, spa, and parking areas may not be included.

There are different types of condo hotel regimes. The type of regime used, and the corresponding project, will depend in large part upon the physical nature of the project, the quality of the project, the requirements of the brand operator and the business goals of the developer. Complex legal requirements and business considerations usually determine exactly which facilities are under undivided common ownership of condo unit owners, and which are retained by the developer, operator or other parties.

What Governmental Approvals are Required for a Condo Hotel Project?

The entitlement process in most jurisdictions can be cumbersome, time consuming, and costly. The condo hotel strategy begins at the initial stage of permitting and creating the condominium "subdivision." (In California, for example, a condominium project is considered a "subdivision"—in other locales different terminology may apply, but the process will be similar.)

The ability to permit and construct a hotel condo project is subject to local laws, land use policies and development standards set forth in the city's (or county's) general plans, specific plans, zoning ordinances, and subdivision ordinances.

Design standards, density and height limitations, parking requirements, affordable housing standards, historic preservation issues, licensing requirements and tenant relocation assistance on a conversion project may all be implicated by local land use policies and development standards. These are the real world issues that come into play whether the condo hotel project involves new construction or the conversion of an existing hotel or multi-family property to a condo hotel.

What's the Process?

Entitling a "traditional" hotel on a single parcel of land typically triggers the need for certain land use approvals to insure, for example, that the zoning allows for hotel "transient occupancy" uses on the property, and certain other discretionary approvals for hotel operations such as a "conditional use permit."

But the legal process for creating the condominium portion of the condo hotel necessarily includes many more steps in the approval process. To describe the process of creating a legal subdivision for the condominium portion of the condo hotel project, we will use California procedures and terminology. They will be similar to the subdivision requirements in many other jurisdictions.

Importantly, a condominium subdivision requires a "discretionary" tentative tract map approval from the city (or county). What that means is that there is no absolute "right" to obtain city approvals for the project; however, if the application is consistent with the zoning and land use designations, and there is no community opposition to the project, and the city staff supports the project, it is more likely than not that the project can be approved by the city with reasonable conditions. Although the requirements can

vary, in most cities the subdivision approval process is as follows: an application for tentative tract map approval is filed with the city planning department; the application is reviewed by various city agencies which will recommend approval or denial of the project; a public notice of the proposed subdivision is sent to owners and occupants located in the vicinity of the proposed project; an environmental review is filed and the city determines whether the project will involve preparation of a full-blown environmental impact report (EIR); and the city Planning Commission conducts a public hearing on the proposed project, after which it will approve or deny the application.

If the decision is appealed or if final approval of the subdivision requires City Council approval, the application is finally heard by the City Council. Approvals may include conditions that must be satisfied within specified time periods.

Some jurisdictions can process condominium subdivision map applications within six months while other jurisdictions can take up to one year or longer to complete the entitlements process. If a project is in an environmentally sensitive area, a longer entitlements process should be anticipated. After subdivision approval, and the conditions of approval are satisfied, a "final" tract map is prepared and recorded. The final map may be a single-lot tract map, and a separate "condominium plan" designating airspace units may be recorded subsequently.

What is a "Condominium Plan?"

The requirement to create distinct legal parcels—which may be sold individually—will be satisfied when the boundaries of a condominium are described in sufficient detail in the recorded final map or the condominium plan. For example, a "condominium plan" will consist of the following: a description or survey map of a condominium project that refers to specific monumentation on the ground; a three-dimensional description of a condominium project, one or more dimensions of which may extend for an indefinite distance, upward or downward, in sufficient detail to identify the separate interests and common areas; and a certificate consenting to recordation, signed and acknowledged by the record owner of fee title to the real property included in the plan.

Condominium Governance and Operation—What are "CC&Rs?"

The basic governing documents of the condominium portion of the condo hotel project are the recorded "declaration of covenants, conditions and restrictions" (or CC&Rs), and to a lesser extent, the HOA's articles and bylaws which contain general provisions concerning operation of the condominium development and the HOA.

The recorded CC&Rs contain a legal description of the common interest development, identify the type of development, set forth the name of the HOA and the restrictions on use or enjoyment of any portion of the development that are intended to be enforceable by or against the condo owners and their successors. The restrictions contained in the recorded CC&Rs are enforceable by the HOA as "equitable servitudes," which "run with the land." In other words, the CC&Rs bind all current and future owners of separate interests in the development to the operating standards of the condominium project. This is key. The CC&Rs will include, for example, all of the essential provisions for the operation of the

development, such as voting rights, use restrictions, and a delineation of the board's ability to contract for goods and services.

There are many keys to a successful condo hotel project, but a thoughtfully and carefully drafted series of condo governing documents are an essential foundation for building the necessary bridges between the condo and hotel parts of the project.

#### How Do CC&Rs Work for a Condo Hotel?

A comprehensive and enforceable set of CC&Rs is a major factor in the successful operation of the condo hotel. The CC&Rs must include virtually all of the operating requirements, standards, rules and regulations required by the condo hotel developer which need to be enforceable by the HOA, (or the hotel operator on behalf of the HOA), against current and future condo owners. The CC&Rs will exclude most of the provisions set forth in the hotel management agreement between the HOA and the hotel operator, but must contain critical enforcement provisions for the HOA to fulfill its obligations to the operator.

Without comprehensive and fully enforceable CC&Rs dictating the standards and conditions of condo ownership in the condo hotel, the quality and integrity of the hotel operation could deteriorate in the event of non-compliant owners, tenants and guests. With the varied types of ownership interests potentially represented in a condo hotel project — ranging from hotel owned rooms (branded or unbranded), individually owned condo hotel rooms, and fractional or timeshare owned rooms, and the various lenders that have an interest in the rooms or the project — it is easy to see how difficult (or impossible) it could be to repair a deficient set of CC&Rs among the various ownership interests.

#### How Does the Hotel Part of the Condo Hotel Maintain an Adequate Supply of Hotel Rooms?

The CC&Rs, HOA articles and bylaws, rental agreements and related documents comprising the condo hotel must ensure the delivery of an adequate inventory of well-maintained condo units into the hotel rental management program for a reasonably long term.

A successful hotel operation requires a minimum critical mass of rooms every night if the hotel is to be successful and viable for all involved—the hotel operator and hotel guests as well as the condo unit owners and the HOA. Without a reliable room availability, guests, travel agents and meeting planners will take their business elsewhere. How do the condo documents and operating facilities assure the availability of a sufficient number of rooms when meetings and conferences have to be booked 12 to 14 months in advance? This is a particularly challenging issue given that an individual unit owner's participation in the rental pool must be on a voluntary basis, and the use of a condo unit by its owner may not be unreasonably restricted.

And of course, the condo documents and operating procedures must ensure through various safeguards, incentives and disincentives that the condos look and feel like hotel rooms and maintain a standard of quality and consistency that guests, operators and brands all demand. The condo governing documents must therefore afford a means to provide adequate capital and operating reserves to pay for

proper maintenance of the building, rooms, facilities, grounds and furniture, fixtures and equipment, as well as to cover hotel operating deficits in the off season or bad times. For all stakeholders to receive what they bargained for, the project must operate successfully as a hotel, not just as a condo project.

#### Selling Condo Units in the Condo Hotel—More Regulation?

The sale of condominium units is regulated by a series of state laws that are intended to insure that the condominium project is sold to the public on the basis of full and complete disclosures to prospective owners.

For example, in California, common interest developments are subject to regulations designed to protect purchasers from fraud, misrepresentation and "sharp practices" during the developer's initial construction and sales period. Developers are required to obtain a "Public Report" (sometimes called a "White Report") from the California Department of Real Estate (DRE) before offering interests in the development for sale to the public. Once issued, the DRE Public Report is valid for a period of five years.

A few words of caution: In California, a developer who sells a condominium without obtaining a Public Report is subject to criminal sanctions and can be enjoined from further sales activity pursuant to a cease and desist order until a public report has been obtained. In addition, a developer's failure to comply with the statutory scheme renders the sales contract voidable at the option of the purchaser. Other states have similar consumer protection laws. There are also securities issues to be addressed in connection with the marketing of condos, specifically when the project developer offers a rental management program to condo buyers.

#### When Can the Revenue Stream Be Turned On?

Developers, hotel operators and lenders are all eager for condo sales to commence at the earliest stage of development. Indeed, we have all seen condo hotel developments that "sell out" the condo portion of the project even before construction commences. While there may be creative ways to "pre-sell" the condos, it is important to recognize that the condo sales cannot "close" until condos have been created as legally recognized parcels of real estate. In other words, the final map for the condo portion of the project must be recorded, the HOA must come into existence, DRE requirements must be satisfied, and the CC&Rs must be in place. Establishing legally compliant condominium units that can be sold to the public is both time consuming and highly regulated. Doing it right will allow developers to move their projects forward with confidence. Doing it efficiently, will enable all stakeholders to begin reaping rewards sooner rather than later.

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