

BRANDED RESIDENCES: TIPS FOR NAVIGATING A SUCCESSFUL PROJECT



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FOREWORD

With its glamorous brand, address, association with and access to an adjoining luxury hotel, a well-designed branded residence project initially appears to offer an “everyone wins” proposal to the participants: the project developer, the hotel operator, and the prospective residence buyer.

However, the respective interests and objectives of the participants can significantly change over the life of the project, and indeed may directly conflict at various stages.

Potential residence buyers obviously need to read the sales documentation carefully and obtain professional counsel before committing to buy.

That said, developers and operators need to be conscious of the various commercial, legal, operational and financial issues that arise over the life cycle of the development and operation of the residence project.

If these issues are addressed up-front through the project structure and documentation, it can significantly minimise future problems and better align the parties interests to deliver a successful branded residence project.

“If potentially conflicting issues are addressed up-front, it can significantly minimise future problems and better assure a successful branded residence project.”



SCOTT ANTEL
Head of Hospitality MEA & Russia/CIS
scott.antel@bclplaw.com

BRANDED RESIDENCES: WHAT'S IN IT FOR THE PARTIES?

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| <div>DEVELOPER</div> <div></div> | <div>For the developer, combining a residential project with a luxury brand hotel offers the prospect of:</div> <div><div><div>→ a potentially significant sales premium on residence sales;</div><div>→ upfront cash flow from residence sales to finance the associated hotel,</div></div><div><div>→ an assured level of level of design style and quality control to the project, and;</div><div>→ the ability to leverage the hotels ancillary facilities (spa, pool, housekeeping, room service, etc.) with use by residence owners.</div></div></div> |
| <div>OPERATOR</div> <div></div> | <div>For the operator, branded residences offer the ability to:</div> <div><div><div>→ leverage the brand to an expanded customer base and business line than just the hotel;</div><div>→ obtain a brand licensee fee (typically 3-5% of a residence's gross sales price) for associating its brand and brand standards with the residence sales;</div></div><div><div>→ additional fees for managing the residence facilities as well as access to the captive residence owners audience for the ancillary Hotel facilities; and</div><div>→ allows operator to better maintain control over the standard and maintenance of any shared front or back of house facilities.</div></div></div> |
| <div>BUYER</div> <div></div> | <div>For the buyer, there is</div> <div><div><div>→ the status and prestige of buying into a luxury brand and lifestyle (very important in many cultures);</div><div>→ brand association assurance that the design, architecture and fit out will be done to a high standard and the project delivered as advertised.</div><div>→ the assurance of high levels of security, and that the property will be well maintained and common rules and</div></div><div><div>regulations enforced. Not to mention the convenient access to the hotel amenities; and</div><div>→ potential enhanced resale value of the branded residences, as well as a potential investment element in those branded residence projects where owners can place their residence into a rental pool forming part of the hotel's room inventory.</div></div></div> |

Sounds like everybody is a winner, right? Well, not before looking at the fine print, including:

- assessing the overall project concept;
- the legal foundation and structure of the documentation supporting the project; and
- the overall transparency of the offering documentation, including the allocation of common charges and other costs.

For despite there being many mutually beneficial attributes, there are as many potentially competing interests amongst the parties arising at various stages of the project. These need to be anticipated and addressed upfront in the project documentation and offering documents, to avoid problems later on.

“Despite there being many mutually beneficial attributes, there are as many potentially competing interests amongst the parties arising at various stages of the project.”

WHAT IS A BRANDED RESIDENCE?

The concept of a branded residence project is still relatively new, but surprisingly the first offering of private residential flats linked with a hotel goes back to 1927, and the Sherry Netherland Hotel on Central Park, New York. However, the concept has evolved considerably since then.

Definition

Branded residence properties are frequently referred to as “condo-hotel”, “serviced apartments” or “shared ownership” schemes (eg time shares, fractional ownership or vacation clubs). There are similarities and differences to these terms, mainly sole freehold ownership by the buyer. Essentially a branded residence, for purpose of this discussion, is a mixed-use development where private residential real estate is sold under a luxury hotel brand name.

“Association with the brand, and the quality assurances and prestige it brings, can enable the developer to achieve a sales price substantially more (often 20-50%) than if sold unbranded.”

Prestige

Association with the brand, and the quality assurances and prestige it brings, can enable the developer to achieve a sales price substantially more (often 20-50%) than if the residences were sold unbranded. Branded residences can be stand-alone developments or, more often, are developed in conjunction with a hotel under the same brand. The branded residence may be in the same or an adjacent building to the hotel, but will usually be a separate complex with separate entrances, reception, lift infrastructure and facilities. Although some hotel facilities (eg gym, pool, spa) may be shared with the residences, as well as services such as housekeeping, laundry and room service.

Design quality

The branded residences will be designed and built in accordance with the operator’s brand standards, pursuant to a Residences Technical Services Agreement between the operator and developer. Typically the residences will have cutting edge architecture and design, and incorporate luxury fittings and appliances. The operator, who is not the project developer and is merely licensing its brand for the marketing and sale of the residences, will typically impose strict conditions on the residence sales agreement and sales process of the residences, to ensure that no misrepresentations are made, along with full disclaimers of the operators non developer/ investor role.

Restrictions

There are strict limitations on the brand’s use by the developer in the marketing and sales activities, and in subsequent identification with the residence project, in the Residence Marketing & License Agreement. There may also be limitations on the regions where, and nationalities to whom, the branded residences may be offered, so as to avoid securities laws disclosure rules (e.g. the US or UK).

Rental programmes

Some branded residence projects include a rental programme, whereby the residence owner may sign a Residence Rental Programme Agreement with the operator to place their unit into the hotel’s rooms inventory. The operator will then market the residence through its distribution channels and take a management fee for this service, with any remaining balance, after the deduction of various allocated operating expenses and charges, going to the owner. Residence owners opting for the rental pool are typically required to decorate and furnish the residence according to the operator standards, although the operator may allow several design palettes and/or kitchen and bathroom designs to choose from. Where the residence will not be rented out, the owner has full creative license in decorating.

“Some branded residence projects include a rental programme, whereby the residence owner may place their unit into the operator’s hotel rooms inventory.”

CONSIDERATIONS FOR GETTING IT RIGHT

THE PROJECT CONCEPT

The first rule for any hotel (or branded residence) project is to do a feasibility study to assess the potential market for the hotel and residences, and to develop the right product, mix, configuration, and the type and standard of the amenities and shared facilities. These analyses should be supplemented with lessons learned from the successes and failures of previous similar projects.

Questions to consider are:

- who is the residences’ target audience? (eg retirees, families, business travellers, Generation Y trendies); and
- what socio-economic level can the residences appeal to and how compatible will those target buyers be with the chosen hotel brand’s target audience?

Residences aimed at affluent retirees are not likely to coexist well with the demographic of a trendy “nightclub” hotel brand such as a Morgans or W. The choice of hotel brand, the design and configuration of the residences and their amenities (kiddie pool, wellness spa, club room etc.) are dictated by these analyses.

Also, what are the prospective buyers’ motives for buying: as a permanent home, a vacation home or as an investment to place into a rental pool? The objectives and expectations of these buyers can vary significantly; the former desiring a small “community” like

atmosphere, the next a maintained ready-to-use holiday home, and the latter concerned more about what yield they can achieve from outside rentals. A project where the majority live full time will also have controls on the minimum length of any third party rentals to avoid a transient atmosphere, whereas a project geared towards investment buyers is likely to be more amenable to shorter rentals.

What amenities should be shared?
Another consideration is which amenities should be shared with the hotel and which kept separate. Full time residence owners seeking a community environment will not take kindly to a private clubhouse that is overrun with transient hotel guests, or where you have to compete with strangers for a pool lounge chair or golf tee time. Right sizing these amenities and determining which to share or keep separate can be crucial to achieving a positive co-habative experience for both the hotel guests and the residents.

Setting rules
Dealing with multiple tenants/ owners, particularly those who are accustomed to being pampered or having their own way, can be very difficult. Limiting the target buyer audience to a premium segment is no guarantee that people know how to behave, or will respect the rights of others in a multi-occupant setting. Meaning that very strict rules and regulations of behaviour (no laundry on the balcony, no

repair works outside certain hours, etc) need to be established and made obligatory on residence owners. The operator is also likely to require that any residence rentals be channeled solely through the operator’s booking system, which will prohibit an owner renting independently or through a third party (eg Airbnb).

Holding developer involvement
Finally, the operator typically will try to keep the developer invested in the project for as long as possible, given their existing contractual relationship. This also means that the developer remains on the hook for any “snagging” items and other common remedial repairs occurring soon after a project opens rather, than the operator being left to deal with them alone. Even where by law or contract the control over the residence common areas is transferred to an owner’s association, operators will still try to retain the developer as owner of various shared facilities (and/or a contracting party to the Common/ Shared Facilities Management Agreement(s)) in order to better retain control over their operation and maintain brand standards. And have the developer as the contracting party with any owners association to avoid any direct legal relations with multiple owners.

LOCAL LEGAL FRAMEWORK

The local legislative framework needs to be carefully considered when developing a branded residence project and structure. For example:



Some jurisdictions restrict foreign nationals from owning real estate. This can sometimes be addressed by converting the freehold ownership to a long term lease or usufruct status or selling cooperative shareholder rights to the residence unit. But be aware that in many cultures potential buyers may view non-freehold interests as unsafe investments, which could impact the project’s marketability.

“It is frequent to see operators insisting on full disclaimers of their involvement in the development and sales process for branded residences.”

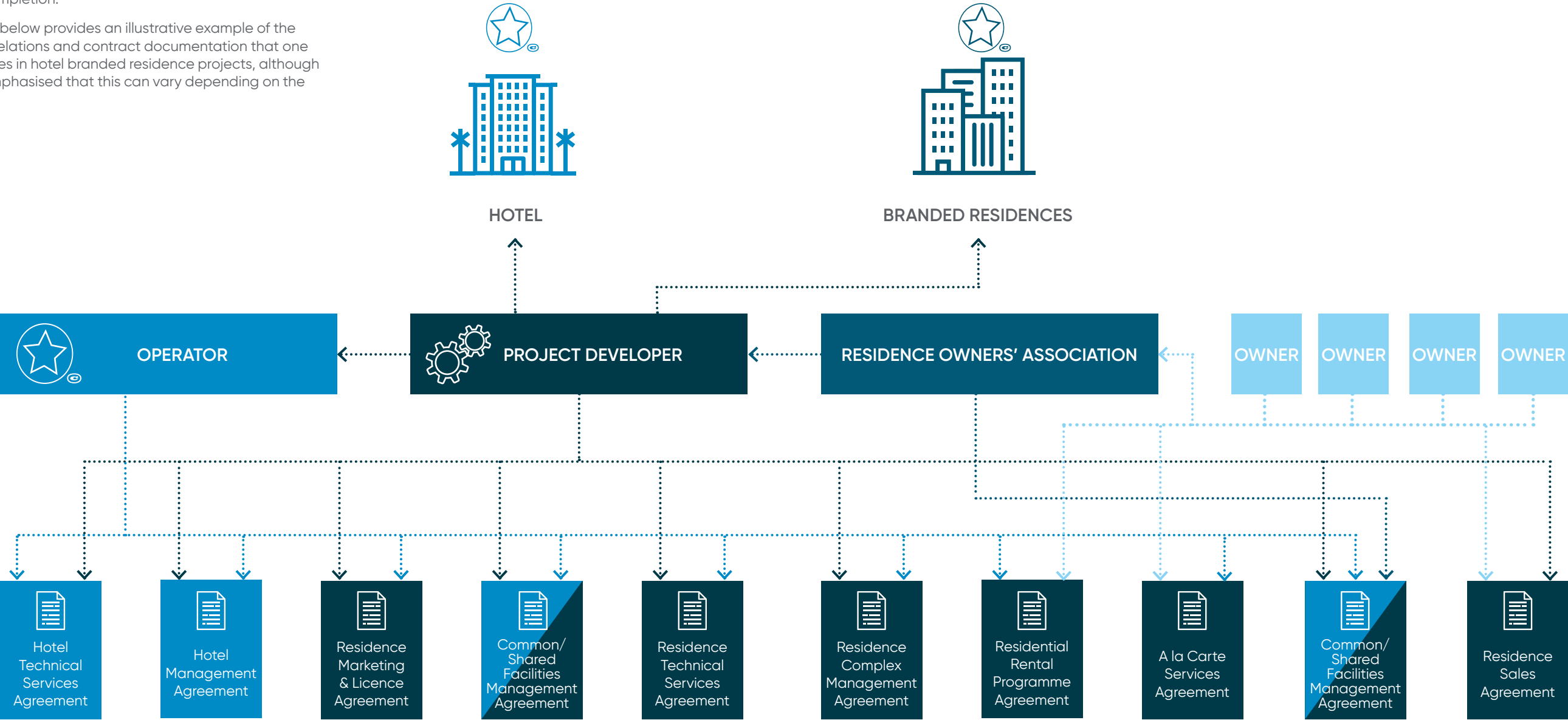
Local zoning and density restrictions may limit the ability to develop and sell branded residential units associated with a hotel. Again, there are ways to address this, eg limiting the uninterrupted period of occupancy by any owner or tenant, or requiring the units to be regularly included in the residence rental pool.

Some jurisdictions (eg the US and UK), particularly where there is a rental scheme and thus an investment component to the sale, treat the sale of branded residence units as sales of securities or subject to collective investment scheme rules. This can bring them within the scope of very complex securities law legislation that require extensive disclosure prospectus details in the residence sales agreement offering, with severe civil and criminal law penalties for violations thereof. For this reason, it is frequent to see operators insisting on full disclaimers of any involvement in the development and sales process for branded residences (other than the license of their brand marks) and there may often be restrictions on selling to certain nationals due to securities laws/disclosure concerns.

HOTEL BRANDED RESIDENCE LEGAL DOCUMENTATION

In most jurisdictions – and particularly developing markets – there will undoubtedly be significant gaps or omissions in the legislation that the respective parties would ideally hope to have before contracting. This requires a certain leap of faith, as well as a certain amount of practical improvisation of the project structure and documentation (some of it relying more on moral persuasion than legal enforceability) to take a project to completion.

The diagram below provides an illustrative example of the contractual relations and contract documentation that one frequently sees in hotel branded residence projects, although it must be emphasised that this can vary depending on the local law.



1 The appendix of this article provides a brief description of the various contracts noted in the diagram and their purpose.

HOTEL BRANDED RESIDENCE LEGAL DOCUMENTATION CONTINUED

In the early stages of the project, only the developer and the operator² are involved to design and develop the concept and structure, the offering documents, and the rules and regulations as to how the branded residences will be managed once the residence units are sold. The diagram (prior page) assumes that the developer will retain a contractual role in the project, even after all the residences are sold, which may not always be the case depending on the developer’s objectives and/or the local legislation.

Jointly owned property
In jurisdictions where there is jointly owned property (strata) legislation, an Owners Association comprised of the residence owners is established by law to assume control over and responsibility for maintenance of the common areas of the residences. This means that the developer gradually cedes control over these areas to the Owners Association (or control over the Owners Association) as more units are sold to buyers. In other jurisdictions where owners associations are not established by law, the parties may nonetheless create them by contract. That said, even where enabling (eg strata) legislation exists, additional laws and regulations necessary to fully implement the legislation and/or empower the Owners Association may be lacking. This needs to be checked carefully.

As earlier noted, the operator will try to keep the developer in the project for as long as possible, if not the entire term, to deal with building defects and to have better control over the maintenance and adherence to the operator’s brand standards for the common and shared facility areas. This is typically done through the operator and developer (and possibly the Owners Associations) contracting through the common/shared facilities management agreement.

Developing well considered rules and regulations
It’s worth noting that when designing the project structure, including the terms of the governance documents; the budgets for common and shared facilities and other service charges; FF&E reserve contributions; and the terms, costs and fees to the operator for managing the residences and any residence rental programme, the prospective Buyer/Owner is not involved in the discussion. On one hand this can be a good thing, if it leaves these matters to experienced professionals who can develop and implement a scheme that enables the residences to be operated to a high standard and deliver a quality experience.

However, if the developer cannot be bothered with these considerations, which will only come into play after it has sold the units and exited, or if the operator’s primary motivation is maximising its residence sales royalty and not the subsequent operational matters, problems will arise. Moreover, simply relying on potential buyers to be enamoured by the project brochures and lifestyle promises, without bothering to read the fine print obligations to fund the repairs, maintenance and management charges before buying, is simply deferring problems to later.

Ultimately, well considered and designed rules and regulations, and transparent information documentation, particularly related to buyer obligations for maintenance, reserve fund contributions and other costs, as well as the fees payable to operator for managing the residence complex and any rental programme, are essential up-front disclosure duties to avoid later disputes. Also, in any offering documentation pitched to potential residence buyers, it is best to be conservative on budget estimates of common charges and to under-promise and over-deliver on any projected investment returns related to a rental programme.

OTHER POST SALE ISSUES

Once the developer has their money (assuming no escrow retention laws) from the residence sales, the operator has its hotel and residence fee streams in place, and the owner is in residence and/or expecting a return on rental of their unit, there remain – or arise anew – additional legal and commercial issues for the respective stakeholders.

Maintaining brand standards
With the hotel component of the project, the operator is dealing with one party (the developer) with whom he has strong contractual assurances under the Hotel Management Agreement for maintenance of the brand standards. However, for the residence component, the ability of the operator to enforce the brand standards under the Residence Management Agreement between the operator and Owners Association is much more dependent on the applicable local legislation, the governance documents and the cooperation of the individual owners and the Owners Association. In some jurisdictions, residence

owners cannot be forced to join or to remain in an owners association, and the obligation of subsequent residence purchasers to join may also be limited. Further, the collection of unpaid management and common charges can be onerous and time consuming. In other jurisdictions, strata laws may limit the term of any residence or Facilities Management Agreement entered into between the operator and the Owners Association to manage the residences or may allow its termination at will, all of which will be of concern to the operator (and some residence owners) in trying to maintain the residence facility to the brand standards.

Costs of branding
In addition to the considerable sales premium associated with branded residences, the costs of maintaining the brand standards can be significant to those of unbranded properties where the maintenance of common facilities, for example, is effectively left to the determination of individual residence owners via the Owners Association. Indeed, over

time a majority of residence owners may determine that the costs of branding and maintaining the brand standards (including costs of brand’s standards changes) are no longer worth it, and they believe they may obtain the prestige and associated amenities of the adjacent brand hotel without their residences being branded. Or owners may object to the costs of renting units solely through the operator’s system and may wish to do so themselves or via third party agents. Many of these potential owner concerns can be addressed – or at least minimised – if the Residence Sales Agreement offering documents transparently set out the costs associated with branding, management and any rental programme, and how the various costs are to be allocated to the residences.

2 And possibly a regulatory approval body in some jurisdictions, particularly where the residences are being sold “off plan” with substantial buyer prepayments.

“Potential owner concerns can be addressed – or at least minimised – if the Residence Sales Agreement offering documents transparently set out the costs associated with branding.”





Loss of the brand’s association with the residences is a major issue, which may come back to bite developers and operators given the brand premiums they receive from marketing the product as branded. ”

Maintenance of brand standards and the loss of branding of the residences are the main reasons why the operator will try, through the contractual structure and documentation, to retain the developer’s control over the project’s common and/or shared facilities, in order to have greater contractual control in enforcing brand standards. The operator can also make residence owners access to the hotel amenities and services conditional on the the residence units remaining branded, although practically any denial of these services would reduce custom to the hotel’s facilities to the detriment of the hotel and the developer.

Loss of the brand

Another major issue which is often overlooked, and has not been well addressed by the courts or in practice, is the situation where the brand is disassociated with the residences.

The operator will include in the Residence Marketing & License Agreement with the developer that use of the brand is solely limited to the marketing and sales of the residences. That or a separate license agreement may also provide for a royalty free right to use and associate the brand with the residences project for so long as the operator (or a third party operator approved by operator) manages the residence facilities and maintains them to the brand standards. There will also be cross-default

language in the Brand Marketing & License Agreement, Residence Sales Agreements and the Hotel Management Agreement that a loss of the Hotel’s association with the Brand automatically results in termination of any rights to use the brand with the residences.

For the operator the primary income generator from branding the residences is achieved upon the residence sales and the operator’s receipt of the average 3-5% royalty fee on the gross sales price. Thereafter, the economic benefits of continued branding and managing the residences (0% royalty; a cost plus management fee; additional hotel revenues from residents availing of the hotel facilities and additional offerings; and possible fees from overseeing any rental programme) may not be worth having to deal with a recalcitrant Owners Association or multiple individual owners, under laws and regulations which may not be as clear or enforceable as their Hotel Management Agreement with the developer/developer they know.

Similarly the developer, who has used the brand to sell the residences at a significant premium, may no longer have a significant interest whether the residences remain branded or not (except to the extent that branding enhances the hotel component of the project, where they retain an economic interest).

But what about the residence buyer who (notwithstanding full disclaimers of any guaranteed association of the brand with the residences) was marketed and purchased a branded luxury residence, at a considerable premium to what they would have paid for an unbranded product. They arguably have a reasonable expectation that the brand and the anticipated brand service standards they paid to be associated with will remain with the property post sale, and be available to enhance any future resale.

A debranding that isn’t caused by the buyer will usually occur for one of the below reasons:

- a developer default under the hotel agreements;
- failure of individual unit owners or the Owners Association to fund or maintain Brand standards; or
- a consensual termination between the developer and operator under the original brand license agreement.

This is a major issue which, while not adequately addressed to date, may well come back to bite in future given the substantial up-front rewards to the developer and operator in marketing branded residences. Potential residence buyers need to remind themselves that they may not always get – at least long term – the brand they were promised and paid for!

Appendix: Glossary of hotel branded residence contracts

Hotel Agreements

Hotel Technical Services Agreement – between the operator and hotel developer whereby the operator provides its brand standards relating to the hotel product design, construction, fire life safety requirements, etc and some advisory consulting to developer to assist the developer to construct the hotel to and in compliance with the brand standard.

Hotel Management Agreement – between the operator and hotel developer whereby the developer engages the operator to, in the name, account and on behalf of the developer, manages and operates the developer’s completed hotel under the operator’s brand and in accordance with the brand standard.

Common/Shared Facilities Management Agreement – between the operator and developer and/or the residence Owner’s Association whereby the operator is engaged to manage the common areas and/or shared front and back of house facilities shared by the hotel and the residence complex to the brand standard.

Residence Agreements

Residence Technical Services Agreement – between the operator and developer whereby the operator provides its brand standards relating to the residence product design, construction, fire life safety requirements, etc and some advisory consulting to developer to assist the developer to construct the residences to and in compliance with the brand standard.

Residence Marketing & License Agreement – between the operator and developer whereby operator agrees to license the use of its brand and marks to developer in connection with the marketing and sales of the residences and to associate the brand with the residences project, with operator’s license fee typically being a percentage (3-5%) of the residence gross sales price.

Residence Sales Agreement – between the developer and the buyer it is the purchase agreement for the sale of the residence to the buyer. It may also include a building management statement or other documentation governing the use of the residence by the buyer and committing them to minimum standards of maintenance, engaging the operator to manage the residence complex and common areas and imposing rules and regulations of behaviour by residence owners (eg common area dress codes, minimum or maximum third party rental of the unit, etc).

Residence Complex Management Agreement – between the operator and the Owner’s Association and/or developer whereby the operator is engaged for typically a cost plus fee to manage the residence complex common areas and facilities to the brand standard.

Residence Rental Program Agreement – between the operator and participating residence owners whereby the operator will include the owner’s residence in the hotel’s room inventory and use its sales and distribution system to market the room to outside guests. The operator takes a management fee for this service with the balance of any revenues, after the deduction of various direct and allocated costs, distributed to the residence owner.

A La Carte Services Agreement – between the operator and a residence owner whereby the operator agrees to extend and provide various hotel guest services (eg room service, housekeeping, concierge services) on account to residence owners’ and then bill them on a monthly/ bi-monthly basis.

GETTING IN TOUCH

When you need a practical legal solution for your next business opportunity or challenge, please get in touch.

Abu Dhabi

Level 20 Al Sila Tower
ADGM Square P.O. Box 109403
Abu Dhabi United Arab Emirates

Dubai

Level 1 Gate Village 10
DIFC PO Box 507222
Dubai United Arab Emirates

Moscow

Capital City Complex
Moscow City Business Centre
8 Presnenskaya Nab. Bldg 1
Moscow 123100 Russia

SCOTT ANTEL

scott.antel@bclplaw.com
T: +971 (0)4 511 9717 (UAE)
M: +971 (0)56 441 8495 (UAE)
M: +7 (0)495 769 1927 (Moscow)