

REAL ESTATE TRANSACTIONS

Branded Residences and the Hotel Owner's Right of Termination

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The concept of private residences within operating hotels has been around since New York's Sherry Netherland Hotel first opened in 1927.¹ That concept took on new life in the last real estate boom as virtually every major branded luxury and/or lifestyle hotel developed included some residential component, with purchasers being sold on the benefits of buying into condominiums branded with and managed by the most exclusive flags in the hospitality market. Perhaps not surprisingly, it has been reported that those branded residences routinely commanded premiums of between 20 and 30 percent over the average price for non-branded residences in the same market.² And while many of those developments suffered greatly during the downturn, with the overall improvement in the economy, there has been a "revival" in the development of luxury hotels containing branded residences, especially in markets that are popular with international buyers, such as New York and Miami.³

While branded residences may provide significant economic benefits to hotel developers, the branding of those residences could create complications for owners and hotel operators when the brands are removed following termination of a hotel management agreement. This issue can

arise when a hotel owner, dissatisfied with its manager and brand, makes the decision to terminate its hotel management agreement and remove the brand from the hotel, including from the residences. It may also arise when either the owner or the operator terminates its management agreement following an event of default. In those situations, the parties are faced with the question of what, if any, potential liability they may have to residential owners who purchased their units with the expectation that they would be housed within a hotel bearing a particular exclusive brand name.

This article examines these issues.

Termination of Agreements

In the hospitality industry, hotel management agreements are terminated for a variety of reasons. Those contracts are sometimes terminated by reason of a default by the hotel owner, such as the failure to pay the hotel operator fees owed under the contract. They may also be terminated by the hotel owner as a result of the hotel operator's failure to comply with its contractual obligations, such as its obligation to act as a reasonable and prudent operator (the contractual standard of care in most hotel management agreements).

And, as explained in our April 30, 2012 and April 17, 2013 columns,⁴ hotel management agreements may be terminated by a hotel owner at will even where no default has occurred because these contracts are terminable under common law and constitu-

tional principles concerning the revocability of agency agreements and personal services contracts.⁵ The ability to terminate a hotel management agreement is, not surprisingly, of critical importance to hotel owners, providing owners with the ability and flexibility to protect their multi-million dollar investments from mismanagement by an unwanted manager and hotel brand. Courts have protected this termination right, refusing to enjoin terminations and even middle-of-the-night takeovers. The reason: hotel management agreements are often both agency contracts, revocable at will by the principal hotel owner, and personal services contracts, the termination of which courts have long refused to enjoin as antithetical to this country's prohibition against involuntary servitude.⁶

Owners of hotels with branded residences, like owners of other hotels, rely on these twin rights of termination to ensure the profitability of their investments. But owners of hotels with branded residences face a unique concern: what rights, if any, do residential owners have with respect to the removal of the brand? As this article explains, provided that proper disclosures have been made in the sales process, an owner of a branded residence will have no rights with respect to such a termination.

Protection From Liability

First, compliance by hotel owners and operators with the disclosure requirements of the Martin Act and the regulations promulgated under that statute can protect a

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hotel owner from claims by condominium owners in the event of a termination of the hotel management contract.

Virtually every state protects consumers from the fraudulent marketing and sale of stocks, bonds, and other securities through what are commonly known as “Blue Sky” laws. In New York and many other states, this protection extends to public offerings of participation interests in real estate, including the marketing and sale of condominium and cooperative apartments.⁷ In order for a sponsor of a condominium development to offer such residences for sale, New York’s Blue Sky law, known as the Martin Act,⁸ requires that the sponsor file an offering plan with the attorney general’s office. The Martin Act is a disclosure-based regulatory scheme and requires “full disclosure of risks and [provides for] unit purchasers’ self-protection by analysis of risks.”⁹ Thus, the Martin Act requires that a developer disclose in the offering plan all information which “will afford potential... purchasers...an adequate basis upon which to found their judgment and [which] shall not omit any material fact or contain any untrue statement of a material fact.”¹⁰

One of the specific disclosures required by the attorney general to be put in an offering plan is a summary of the terms of management contracts affecting the condominium, including hotel management agreements. These required disclosures include, among other things: (i) the term of the contract and the manager’s cancellation rights; (ii) whether the contract may be assigned by the manager; and (iii) the right of the board of managers of the condominium to cancel the agreement, with or without cause.¹¹

Thus, many offering plans for branded condominiums include a disclosure that the agreement with the hotel brand can be terminated at any time, resulting in the removal of the hotel brand from the condominium. Similarly, many offering plans expressly disclose that there are no guarantees that the hotel will be operated by or be affiliated with a particular brand. Finally, most offering plans with branded condominiums provide that there are no representations or warranties of any kind that the hotel is or will continue to be operated as a hotel by the current hotel operator or have any brand affiliation.

Moreover, many hotel operators will specifically require purchasers of branded condominiums to execute acknowledgements providing that the purchaser recognizes that the hotel management agreement may be terminated or may expire without renewal, in which case the

hotel and the condominium would no longer be identified with the then-current brand.

Provided that hotel owners and operators comply with the disclosure requirements under the Martin Act and make the foregoing disclosures, a prospective purchaser will have a wide array of information concerning the contractual relationship between the developer and manager, including the contractual rights of termination.

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However, the attorney general does not expressly require that a developer disclose that under common-law rules governing both principal-agent relationships and personal services contracts in New York, both the developer and the manager have the unfettered and unilateral right to terminate their hotel management agreement, subject only to a claim for damages.¹² Because not expressly required, many offering plans do not have a full recitation of these extra-contractual rules of law, although they should in order to provide maximum protection to the parties.

The natural question that arises is whether the failure to disclose these rights exposes them to liability from disgruntled purchasers, who believed they were buying into a specific management brand, when the building owners decide to exercise their unfettered right to terminate the management agreement and remove the brand from the property. Although we are not aware of any case directly addressing claims relating to a failure to disclose a common law right to termination of a hotel management agreement, the existing Martin Act case law addressing the purported non-disclosure of aspects of an agreement otherwise properly summarized in the offering plan demonstrates that neither condominium owners nor the attorney general would be able to assert such a cause of action.

For example, in *East End Owners Corp. v. Roc-East End Associates*,¹³ the cooperative corporation and the tenant-shareholders of the cooperative brought claims against the sponsor concerning a garage lease the plaintiffs alleged was a “sweetheart” agreement that had no valid business purpose other than to circumvent certain regulations. In that case, the financial provisions of the lease at issue were fully disclosed in the offering plan, but the plaintiffs nonetheless maintained that the sponsor had violated the Martin Act and committed common law fraud by failing to disclose the sponsor’s reasons for entering into the lease and the fact that there was an ongoing relationship between the sponsor and the garage lessee.

The First Department dismissed the fraud claims because any alleged loss from the non-disclosure of the “sweetheart” agreement was “readily discernible from analysis of the financial terms of the lease which were fully disclosed in the offering plan.”¹⁴ Accordingly, the First Department held that “[w]here a party has means available to him for discovering, ‘by the exercise of ordinary intelligence,’ the true nature of a transaction he is about to enter into, ‘he must make use of those means, or he will not be heard to complain that he was induced to enter into the transaction by misrepresentations.’”¹⁵ Because the plaintiffs “had, in the offering statement, the means for discovering whether the rental to be paid under this lease was reasonably related to current market rates or not,” the First Department held that the cooperative tenants could not maintain a cause of action for fraud.¹⁶

As in *East End Owners*, provided that a hotel owner has summarized the terms of the hotel management contract in its offering plan and otherwise complied with the disclosure requirements of the Martin Act, owners of hotels with branded residences should be protected from liability to condominium owners and the attorney general with respect to the exercise of its common law right to terminate its hotel management agreement and remove the brand from both the hotel and residences. The common law right of termination can be discovered by purchasers of branded condominiums “by the exercise of ordinary intelligence” once the terms of a hotel management agreement have been disclosed.¹⁷

Compliance With ILSA

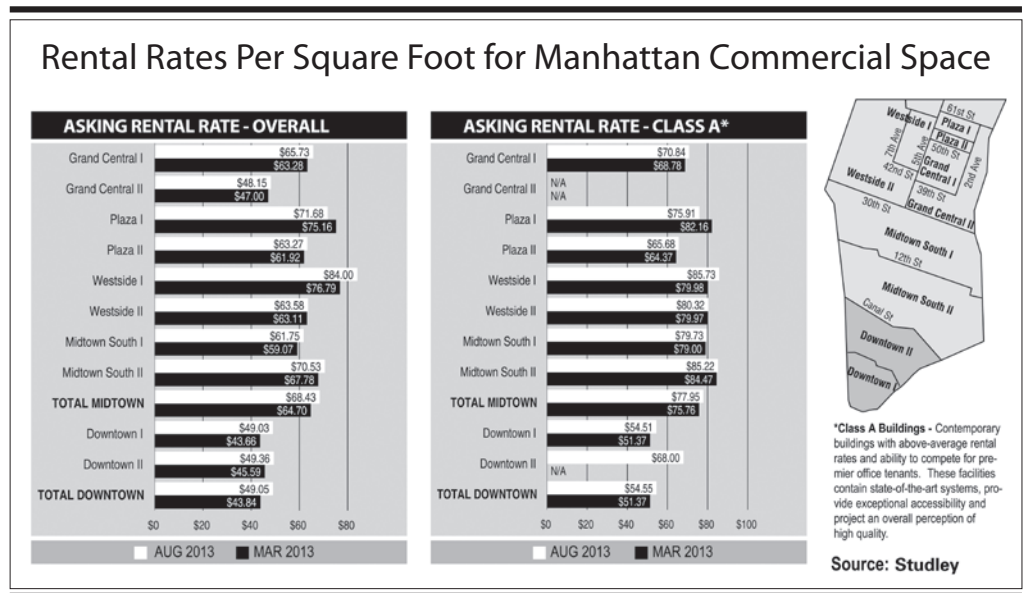
Compliance by hotel owners with the disclosure requirements of the Interstate Land Sales Full Disclosure Act (ILSA) can further protect

a hotel owner from claims by condominium owners in the event of a termination of the hotel management contract.

ILSA, like the Martin Act, is a disclosure statute whose purpose is to protect purchasers from false and deceptive practices by sellers of real estate. Modeled after the Securities Act of 1933, ILSA requires developers who employ interstate commerce or the mails to sell or lease “lots” in “subdivisions” to, as relevant to this article, disclose specified and material information to potential buyers. ILSA’s principal disclosure devices are the “statement of record” to be filed with the Department of Housing and Urban Development (HUD) and the “property report” to be provided to the buyer or lessee in advance of signing the purchase agreement or lease. Unless the seller has done both, a purchaser of a non-exempt “lot” may be entitled to rescind the purchase agreement within two years of signing.

Earlier this year, the U.S. Court of Appeals for the Second Circuit held that ISLA and its disclosure requirements applied to the sale of condominiums, although a petition for en banc review is currently pending.¹⁸ Accordingly, at least until the Second Circuit rules on the petition for en banc review, a developer of a hotel with branded residences that terminates its hotel management agreement could face exposure under ILSA unless it has fully disclosed the nature of the hotel management agreement in its property report.¹⁹

That was precisely the situation in *Nahigian v. Juno-Loudoun, LLC*.²⁰ There, the plaintiff-purchasers purchased a residence in a luxury golf course community in Loudoun County, Virginia.²¹ The Ritz Carlton Hotel Company, LLC was to be the operator and manager of the golf course and other recreational amenities at the development. And the master declaration that each purchaser received represented that “[i]t is anticipated that the Master Association...will enter into a management contract with Ritz-Carlton Hotel Company, LLC.”²² The residence was marketed to the general public as a “Ritz-Carlton Managed Community” using the Ritz Carlton trademark.²³ But two years after the plaintiff-purchasers entered into a contract of sale for a residence at the development, Ritz Carlton terminated its operating agreement.²⁴ There was no dispute that the developer had failed to provide the property report required by ILSA and, after learning of the termination of Ritz Carlton’s operating agreement, the purchasers sought rescission under §1709(a) of ILSA. Because the purchasers did not exercise their automatic right to



rescission within two years, they were required to show that the failure to provide the property report was “objectively material.”²⁵

The U.S. Court of Appeals for the Fourth Circuit held that the failure to provide a property report was objectively material because the developer would have been required to disclose the limited nature of Ritz Carlton’s involvement in the project. Specifically, the Fourth Circuit held, in light of the fact that the homes were marketed as Ritz Carlton residences with the Ritz Carlton logo and brand “prominently advertised,” that had the information concerning Ritz Carlton’s contract for the management of the property been properly disclosed, the purchasers “may not have entered into the purchase contract had they known the limited extent of Ritz’s involvement at that time, and they would have exercised their automatic right to rescission under [ILSA] had they been aware of it.”²⁶

Conclusion

As these cases make clear, provided that hotel owners and operators have fully complied with the disclosure requirements of these statutes, the fact that they have sold branded condominiums within the hotel should not preclude either from exercising their termination rights, including the hotel owner’s absolute common law right of termination. However, these cases also demonstrate that where those parties have not fully complied, they may face liability to condominium purchasers unhappy with the removal of the brand from their residences.

Accordingly, it is essential that, before making the decision to terminate a hotel

management agreement, owners and operators of hotels with branded residences fully analyze not only their hotel management agreements but also the offering plans, property reports and condominium purchase and sale agreements so as to fully understand the risks of termination.

1. Liam Bailey, Newmark Grubb Knight Frank, “Branded Residences—Where Is the Trend Heading?” (Dec. 20, 2011).
2. Kris Hudson, Wall Street Journal, “A Hotel-Condo Revival” (Feb. 5, 2013).
3. *Id.*
4. Todd E. Soloway and Joshua D. Bernstein, “The Termination of Hotel Management Agreements,” New York Law Journal (April 18, 2012); Todd E. Soloway and Joshua D. Bernstein, “The Termination of Hotel Management Agreements: Part II,” New York Law Journal, (April 17, 2013); see also *Marriott Int’l v. Eden Roc*, 104 A.D.3d 583 (1st Dept. 2013).
5. *Id.*
6. *FHR TB v. TB Isle Resort*, 865 F. Supp. 2d 1172, aff’d, 2011 U.S. Dist. LEXIS 155752 (S.D. Fla. 2011); *Woolley v. Embassy Suites*, 227 Cal. App. 3d 1520 (Cal. Ct. App. 1991); *Pacific Landmark Hotel v. Marriott Hotels*, 19 Cal. App. 4th 615 (Cal. Ct. App. 1993); U.S. Const. amend. XIII.
7. *Kerusa Co. v. W10Z/515 Real Estate*, 12 N.Y.3d 236, 243 (2009); *East End Owners Corp. v. Roc-East End Assocs.*, 128 A.D.2d 366, 368-69 (1st Dept. 1987).
8. N.Y. GBL §352-e.
9. *Kerusa Co.*, 12 N.Y.3d at 243.
10. N.Y. GBL §352-e(1)(b); *Kerusa Co.*, 12 N.Y.3d at 243-45.
11. 13 NYCRR 20.3(aa).
12. *Marriott Int’l*, 104 A.D.3d 583.
13. 128 A.D.2d 366 (1st Dept. 1987).
14. *Id.* at 370.
15. *Id.* at 370-71.
16. *Id.*
17. *Id.*
18. *Berlin v. Renaissance Rental Partners*, No. 12-2213-cv (2d Cir. May 6, 2013).
19. 15 U.S.C. §1701 et. seq.
20. *Nahigian v. Juno-Loudoun, LLC*, 677 F.3d 579 (4th Cir. 2012).
21. *Id.*
22. *Id.* at 583.
23. *Id.*
24. *Id.* at 584.
25. *Id.* at 589.
26. *Id.* at 591.