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Tough Locations Produce Complex Litigation

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A pair of recent buyer's remorse court decisions illustrate that great brands can't overcome questionable location selections. Efforts at blame-shifting were unsuccessful, but at least one group of claimants will get another pass at making its claims stick. While these cases were decided under different theories, the location issue underlies all of the claims.

Not Exactly Paradise

The Hard Rock Hotel San Diego (HRHSD)[1] was developed as a 420-room hotel condominium project in the city's Gaslamp district with ownership unit prices ranging from $350,000 to $2 million. Each owner signed a purchase and escrow contract, a rental management agreement and a maintenance and operating agreement. Tarsadia Hotels, an experienced hotel owner/operator, developed and operated the franchised hotel through affiliates. Owners were limited to 28 days of use, and their occupancy of their own units was controlled by the hotel manager. None had a key to the unit represented by their ownership interest. While they were not obligated to sign a rental management agreement, the real estate value of each unit was a function of the number of days it was rented. The owners argued that there was little practical choice but to rent through the rental management agreement. The documents included substantial disclaimers about the nature of the investment, described as a real estate transaction and not as a common enterprise where the owners' capital was at risk in a pool of risk capital.

The San Diego market was overbuilt and the notional returns for the HRHSD owners apparently were not achieved. The hotel condo owners filed an action in federal court in December 2009, alleging that the ownership interests were investment contracts, not real estate transactions, and thus were securities. Since the interests were not registered and had been sold without regard to any available exemption from registration, the owners alleged violation of federal and California securities laws. In this case, the owners argued that the disclaimers were irrelevant to the economic reality, and that the only realistic chance of realizing any value was through the hotel rental arrangement. But the owners failed to make certain factual allegations critical to this theory, so the U.S. District Court in San Diego dismissed the complaint without prejudice at the request of the hotel developer parties. The owners will be allowed at least one more attempt to advance their economic reality theory. A 1989 case involving a hotel in Hawaii where condominium interests were sold to persons outside Hawaii went to trial in the Ninth Circuit using a similar theory. If the owners are successful in defeating a motion to dismiss by the developer when their amended complaint is filed, securities laws will offer a new avenue for disgruntled hotel condo owners to seek recompense for their unsatisfying purchase decision.

Brand Leverage at the Edge[2]

Ritz Carlton has established a brand synonymous with luxury, wealth and prestige. A real estate developer entered into a series of agreements with The Ritz-Carlton Hotel Company in 2004 for the development of luxury golf course communities. Ritz would not develop the property or sell the homes or lots, but would instead provide technical services for golf course development, and then manage the golf club and recreational amenities of the community. The first project was to be located in Loudon County, Virginia, in the outer reaches of the Washington, D.C. suburbs. The core transaction agreement prohibited the sale of the real estate under the Ritz-Carlton brand, although Ritz was to receive a royalty of 5.5% of the gross sales of lots in the development. The developer never advertised the Ritz brand as a seller of the land. It produced a few marketing pieces that mentioned the Ritz-managed golf course. The covenants of the development were named "Master Declaration of Conditions, Easements, and Restrictions for The Ritz-Carlton Golf Club and The Estates of Creighton Farms," and stated that "it is anticipated that the Master Association (the homeowners association or "HOA") will enter into a management contract with Ritz-Carlton Hotel Company, LLC."

A sophisticated investor couple purchased a lot in June 2007, before the development had any residents. The golf course was not scheduled to open before April 2008. Despite the absence of any agreement, as of June 2007, Ritz was providing some services which would have been performed under a management agreement with the HOA, including landscaping along the roads of the development and providing security for the gates. The couple was given access to a reciprocal Hotel Reservation Service by Ritz-Carlton providing them with discounted rates, upgrades and other benefits at participating Ritz-Carlton hotels. Although no definitive management agreement between Ritz and the HOA was ever executed, advertising approved by Ritz stated that the development was to be a "Ritz-Carlton Managed Community." A sales representative employed by the developer repeated this language and even displayed the Ritz trademark. Marketing brochures displayed the Ritz trademark, but contained this disclaimer:

Creighton Farms is not owned, developed or sold by The Ritz-Carlton Hotel Company, LLC. Juno Loudoun, L.L.C. uses the Ritz-Carlton marks under license from The Ritz-Carlton Hotel Company, L.L.C. Juno Loudoun, LLC is the owner and developer of the project. Developer will enter into an agreement with The Ritz-Carlton Hotel Company (R-CHC) or an affiliate for the management of the golf club and master association.

The purchasers never included any provision in their land purchase contract that made the contract conditional on the formalities of the Ritz affiliation. They closed, with a highly negotiated contract, upon advice of counsel. Out of 100 lots, only 32 were sold, and only 14 sold to builders for construction. Ritz terminated its relationship in 2009. The purchasers never received any of the required disclosures under the Interstate Land Sales Act (ILSA). They sought redress for their situation by seeking to hold Ritz liable as a "developer" or "agent" under ILSA, which would then provide a right of revocation for the aggrieved land buyer against Ritz. They also sought relief under Virginia consumer protection laws.

The evidence showed that the developer did not always obtain the consent of Ritz for marketing materials using the Ritz logo. Violations were met with notices to discontinue unauthorized use. Despite the murkiness of the marketing affiliation, Ritz was not a party to any contract to purchase real estate in the development, was not in the chain of title and was never proven to have had any knowledge of particular lot sales transactions. The court found that Ritz was not a developer under the ILSA and was not liable for revocation of the sale contract.

Leveraging the famous brand in third party real estate development is thought to offer revenue with low capital risk. This case demonstrates that the risk of adverse consequences is not zero, and such licenses demand vigilance over the licensee to avoid entrapment by consumer protection statutes with broad reach as the licensee's efforts become more desperate and dependent on the power of the licensed brand.

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1. *Tamer Salameh, et al., Plaintiffs, vs. Tarsadia Hotels, et al., Defendants. No. 09CV2739 DMS (CAB), 2010 U.S. Dist. LEXIS 87225 (S.D. CA 2010).*

2. *Keith Nahigian, et al., Plaintiffs, v. Juno-Loudon, LLC., et al., Defendants. 2010 U.S. DIST. LEXIS 86401 (E.D. Va/. 2010).*