

ANALYZING, COMPARING AND CHOOSING AMONG FRACTIONAL VACATION OWNERSHIP OPTIONS

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INTRODUCTION

Although fractional ownership is by far the fastest growing segment of the vacation home market, it is still a relatively new concept, and its many possible variations continue to be explored. The constantly changing array of fractional property options, along with a lack of consistency in terminology, can create confusion for buyers, and make informed decision-making difficult. This article is intended to help you understand, analyze and compare fractional vacation ownership options, ranging from buying into an individual home or condominium with friends or family, to buying into a private residence club resort offered by Ritz Carlton or Four Seasons.

UNDERSTANDING FRACTIONAL REAL ESTATE OWNERSHIP TERMINOLOGY

Fractional real estate terminology is mostly used to sell rather than to explain, and some sellers will use whatever terms, distinctions and definitions they think will appeal to their target market, regardless of accuracy or consistency. This summary of some of the most commonly used and misused terms will help you navigate through the sales talk and make informed buying decisions.

“Equity” versus “Non-Equity”

In the fractional vacation real estate world, the term “equity” is used to mean ownership. In equity fractional arrangements, the participants own and use the shared property, while in non-equity arrangements they only use it. Ownership may mean being named on legal title to the shared property, or owning a trust, company or other entity that owns the shared property. The property that is fractionally owned may be a single home, multiple homes, or a multi-unit resort. In general, equity fractional arrangements are less risky, provide tax advantages, give the owners a greater degree of control over the shared property, and are more likely to hold value or appreciate over time. But like all generalizations, these can be misleading, and it is important to examine the merits of each particular offering. Later portions of this article will provide the tools you need to do that.

“Deeded” and “Titled”

In “deeded” and “titled” fractional arrangements, the participants are listed on the legal title to the property. The property that is deeded may be a single home, multiple homes, or a multi-unit resort. Contrary to common misunderstanding, many timeshares are deeded and many fractionals and private residence clubs are not. The advantages of deeded fractional ownership are typically exaggerated, and the disadvantages are rarely appreciated. Compared with other equity fractional vacation arrangements, the advantage of deeded ownership is superior tax treatment for U.S. taxpayers who own U.S. fractional property, but this advantage only exists if all the fractional owners use the property exclusively as a residence. Other supposed advantages, such as better resale value, more owner control, and lower risk, are illusions.

Moreover, deeded ownership has some significant disadvantages compared with other types of equity fractionals. Inadequate or improperly prepared fractional ownership documents (or worse, no documents at all) cause much more significant and expensive problems in deeded ownership than in non-deeded ownership. Deeded arrangements also have more cumbersome financing and resale procedures, and higher liability risks. If the shared property is not within the U.S., U.K. or other country with a quick, inexpensive and efficient system for transferring ownership and a well-developed non-judicial enforcement system, deeded ownership should be avoided.

“Timeshare”

Timeshare is perhaps the most misunderstood term in the fractional vacation property lexicon, largely because of the desire of many sellers to distance themselves from the high-pressure sales tactics, poor quality, and dismal resale performance of many “first generation” timeshare projects. Under the common legal definition, timeshare describes any arrangement where usage of property is shared based on time, and there is no reliable distinction between properties marketed as timeshares and those marketed as fractionals or private residence clubs. As noted above, many timeshares are deeded and many fractionals and private residence clubs are not. It is also worth noting that, bad reputation notwithstanding, many major branded resort developers (including Ritz Carlton, Hyatt and Marriot) are successfully marketing properties as timeshares, and surveys show that the vast majority of those who have purchased timeshares in the last seven years are thrilled with their purchases, have bought additional timeshares in the same or another development, and have encouraged their friends and family to buy timeshares.

“Fractional Ownership”, “Co-Ownership” and “Shared Ownership”

The terms “fractional ownership”, “co-ownership”, and “shared ownership”, can describe any arrangement where two or more people share ownership of something, regardless of whether they have a time-based usage arrangement. “Fractional ownership” seems to be emerging as the one most commonly used for time-based sharing of vacation property in the U.S., but “co-ownership” and “shared ownership” are frequently used to describe these arrangements in other English-speaking countries.

“Private Residence Club”, “Destination Club” and “Vacation Club”

The terms “private residence club” (or “PRC”), “destination club”, and “vacation club”, mean different things to different sellers, and definitions can be misleading. But generally, private residence clubs involve equity ownership (although not necessarily deeded ownership) of a specific property with 4-13 owners per home, and tend to be on the high end of fractional ownership options with regard to unit size, amenity level and pricing. In most PRCs, usage is not unit-specific, meaning that a particular owner uses whichever unit (of appropriate size and type) happens to be available during his/her usage period.

Destination clubs and vacation clubs commonly involve multiple homes in different locations, with a usage system that allows participants to use any of the homes in the club. There are equity and non-equity variations, distinguished by whether or not the participants have an ownership interest (which can be deeded or non-deeded) in one or more homes controlled by the club. Both equity- and non-equity clubs often refund a portion of the purchase price after a pre-set number of years of participation. In non-equity clubs, the refund is generally based on the original purchase price, or on the price being charged for new memberships at the time of the member’s exit, while in equity clubs, the payout is based on the market value of the properties owned by the club.

“Condominium Hotels”, “Condo Hotels”, and “Condotels”

The terms “condominium hotels”, “condo hotels”, and “condotels” usually describe a hotel that has been subdivided into condominiums, where each owner owns the entirety of a specific condominium. Management operates the hotel and shares the proceeds with the condominium owner, who can also use the property him/herself, sometimes free of charge and sometimes for a fee. When there is only one owner per condo, these arrangements are not fractional ownership. But the terms are sometimes used to describe a hotel that has not been subdivided, where the owners own a percentage of the whole development rather than the entirety of a specific room or suite. When used in this way, the terms describe a type of fractional ownership, but the arrangement does not actually involve a condominium.

COMPARING FRACTIONAL VACATION OWNERSHIP OPTIONS: THE KEY ISSUES

Fractional ownership is a great idea, but the details can seem complex to the uninitiated, and it is hard to know the right questions to ask, which type of fractional arrangement is best, and how to choose the right property. This section identifies 11 key criteria to probe and compare:

- Cost-Per-Night-Per-Square-Foot
- Fractional Pricing Multiplier
- Usage Allocation
- Exchange Programs
- Activities and Services
- Group Size and Context Within Larger Organization
- Developer Experience and Branding
- Non-Owner Usage and Rentals
- Owner Control
- Resale and Exit Opportunities
- Legal Documents

Understanding these issues will give you all the tools you need to become an educated and informed fractional buyer.

Fractional Real Estate Cost-Per-Night-Per-Square-Foot

Since each participant in a fractional vacation arrangement is entitled to use the shared property only part of the time, any cost analysis and comparison of fractionals must express cost in terms of usage allotment. And since usage is generally allocated as a certain number of days, weeks or months each year, the best way to calculate the cost/usage relationship is by determining the annual cost of ownership, and dividing that by the annual allotment of usage nights. The cost per night figure must then be divided by the property's square footage so that the resulting figure takes property size into account. By using the annual cost of ownership rather than the purchase price, cost-per-night-per-square-foot includes owner dues, assessments, maintenance fees, and usage fees. These ongoing costs are a significant component of the annual cost of fractional ownership, and ignoring them can distort the results of a cost comparison.

Step 1: Determining Annual Cost of Ownership

As noted above, the annual cost of a fractional is the sum of two components: (i) purchase price, which represents money you could have used or invested elsewhere; and (ii) ongoing annual costs, such as owner dues, assessments, maintenance fees, and usage fees. To determine annual cost accurately, you must first translate the purchase price into an annual cost. In a non-equity fractional ownership arrangement, divide the price by the number of years of usage, then add the interest you would have earned had you invested the same money for the same period of time. For example, if the price was \$400,000 and you were entitled to 10 years of usage, the calculation would be:

Divide price by years of usage: $\$400,000/10 = \$40,000/\text{yr}$
Calculate lost investment return: $3\%^{**}$ of $\$400,000 = \$12,000/\text{yr}$
Add the two numbers: $\$40,000 + \$12,000 = \$52,000/\text{yr}$

[**Throughout this section, I will use an interest rate of 3% based on current returns for low-to-moderate risk investments.]

In cases where a portion of the original price is refunded after a period of time, apply the same approach to the difference between the original price and the refund amount. For example, if the price is \$800,000 and the refund is 75% after 10 years, the calculation would be:

Subtract refund from price: $\$800,000 - \$600,000 = \$200,000$
Divide net price by years of usage: $\$200,000/10 = \$20,000/\text{yr}$
Calculate lost investment return: 3% of $\$800,000 = \$24,000/\text{yr}$
Add the two numbers: $\$20,000 + \$24,000 + \$44,000/\text{yr}$

In an equity fractional ownership arrangement, translating purchase price into annual cost is complicated by the potential for property appreciation or depreciation. In a sense, the calculation is similar to the second example above, except that (i) you

do not know how many years you will keep the property, and (ii) you do not know how much of the purchase price you will get back through sale. But since the primary purpose of the analysis is to compare one fractional interest to another, you do not need to know these answers so long as you use consistent assumptions. For comparison purposes, you might assume that you will keep each property for 10 years, and that each will appreciate 20% over that period. If you think appreciation potential differs among alternative properties, adjust the appreciation assumption accordingly. Here, we assume the purchase price is \$800,000 and the appreciation will be 20%, over 10 years, or \$160,000. This appreciation must be balanced against the interest lost on the \$800,000 investment. The calculation would be:

Project annual appreciation: 2% of \$800,000 = \$16,000/yr
 Calculate lost investment return: 3% of \$800,000 = \$24,000/yr
 Subtract appreciation from lost return: \$24,000 - \$16,000 = \$8,000/yr

So far, our calculations have been based upon a cash purchase. If a portion of the price is financed, perform the “lost investment” calculation on the down payment, and then add interest on the amount borrowed. For example, using the price and appreciation figures from the last example, and assuming \$400,000 is financed at 6%, the calculation would be:

Project annual appreciation: 2% of \$800,000 = \$16,000/yr
 Calculate lost investment return: 3% of \$400,000 = \$12,000/yr
 Calculate loan interest: 6% of \$400,000 = \$24,000/yr
 Add lost return to loan interest, then subtract appreciation: \$24,000 + \$12,000 - \$16,000 = \$20,000/yr

After you translate the original purchase price into an annual cost, add the annual costs including owner dues, assessments, maintenance fees, or usage fees. Sellers sometimes try to make a fractional interest seem more attractive by understating maintenance fees, or not including adequate reserves for replacement of the portions of the property that will wear out over time (including smaller items such as cookware, towels, bedding, furniture, electronics, appliances etc.), so be sure to examine the underlying budget and the list of items included in the reserves. If items are missing, add them in before performing your calculations. Look at the budget and reserves for the properties you are considering side by side to make sure that they all include the same items. Make sure you do not choose a property based on its lower fees, only to discover later that the actual operating costs are much higher. Once you feel confident that you have an accurate number for the annual fees, add that number to your purchase price calculations. The total of the two figures will be the annual cost of ownership.

Rental income can offset the annual cost of ownership. If you are comparing fractional properties with similar rental policies and rental potential, you can ignore the potential impact of rental income because it will have the same effect on the numbers for each property. But when comparing properties with different rental policies or potential, you will need to adjust the figures based on projected rent. Begin by calculating the total number of nights you are likely to rent out the property, taking into consideration your own usage plans and the likely vacancy factor (the percentage of the time when you want to rent out the property but management cannot fill it). Next, calculate the rent you are likely to receive, subtracting any fees, commissions, advertising or other expenses you will pay. Then, subtract the net rental income from the annual cost of ownership.

Step 2: Determining Cost-Per-Night

Cost-per-night is the annual cost of ownership divided by the number of nights of usage. For example, if each owner is entitled to 42 days (six weeks) of usage, and the annual cost of ownership (purchase price plus annual fees) is \$24,000, the cost-per-night is \$24,000/42 or \$571. The calculation is more complex where each participant is allowed unlimited usage subject only to reservation rules and availability. To analyze and compare these offerings, discount the number of nights you think you will use the property by a factor of 30%. The discount takes two factors into consideration: (i) the vast majority of vacation home owners use their property much less than they expect; and (ii) there will be occasions when the property will not be available when you want it and your schedule will prevent you from substituting available alternative times. So, for example, if you think you will use the property 50 nights a year, discount that 30% to 35 nights, then divide the annual cost of ownership by 35 to calculate cost-per-night

Step 3: Determining Cost-Per-Night-Per-Square-Foot

In general, you will calculate cost-per-night-per-square-foot by dividing cost-per-night by the square footage of interior living area of the home you will be occupying, or by the average square footage of interior space of the group of homes you will be occupying. For example, if the cost-per-night is \$571, and the home you will occupy is 3500 square feet, the cost-per-night-per-square-foot is 0.16.

If some or all of the fractional properties had a significant amount of private outdoor living areas (such as patios or porches), you may want to include these in your calculations. Generally, outdoor areas are not given the same value as indoor areas, so you will probably want to apply a discount factor. I recommend discounting the value of private outdoor living areas by 75% compared with indoor living areas. So, for example, if a home has 3500 square feet of interior living plus 2000 square feet of private porch, you would discount the outdoor area by 75% to 500 square feet, and consider the total square footage to be 4000. If the cost-per-night is \$571, the cost-per-night-per-square-foot would then be 0.14.

Fractional Real Estate Pricing Multiplier

Fractional pricing multiplier, which describes the relationship between the price of a fractional ownership interest and the price of whole ownership of a similar property, is an additional way to compare the cost of fractionals. To calculate fractional pricing multiplier, add the cost of all the fractional shares being offered in a particular home, and divide the total by the fair market value of a home that is similar in size, location and amenities. To illustrate, imagine a private residence club selling eight shares per villa for \$350,000 each, and assume that a nearby villa of similar quality and size generally sells for \$1,600,000. The calculation would be:

Total cost of fractional shares: $8 \times \$350,000 = \$2,800,000$
Fair market value of similar home: \$1,600,000
Divide share cost by home value: $\$2,800,000 / \$1,600,000 = 1.75$

Generally, the higher price of properties being sold fractionally reflect the cost of additional furnishing, legal structure, and marketing, but a very high multiplier can indicate an overpriced fractional. When comparing fractional pricing multipliers, ask yourself whether the additional features or qualities of the higher-multiplier property justify the additional markup.

Fractional pricing multiplier is most easily calculated when each fractional being compared involves ownership of a particular property. The multiplier approach can be used for arrangements involving ownership of a group of homes at different locations, but it is necessary to aggregate the fair market values of comparable homes at each location. Fractional pricing multiplier is not helpful for comparing non-equity fractional arrangements.

Fractional Vacation Ownership Usage Allocation

The usage allocation system for a fractional vacation property decides who can use the property when and, in fractional arrangements involving usage of more than one property, which home an owner will visit. There is no best usage allocation system. Whether a system will work well for a particular fractional ownership buyer will depend on the buyer's family status, job, vacation patterns, mode of transportation to the property, and other factors. This part of the article will help you understand the pros and cons of the most common usage allocation systems, and guide you through the process of identifying which usage system is best for you.

Fractional Ownership Usage Systems To Avoid

While there is no best usage allocation system, there are certain systems to avoid. The first is the "we'll just work it out" system. Aside from the inability to plan ahead, the main problem with this approach is that working it out may become more difficult over time, as the participant's lives change, kids get older, people die or sell, and other events alter the original assumptions. The "we'll just work it out" system does not work over the long run for anyone, but it is particularly problematic for those who are most likely to adopt it, namely groups consisting of long-time friends or family members. Even if you plan to handle things informally, create a usage allocation system to fall back on if you are unable to "just work it out".

The second system to avoid is the "first-come-first-served" system, meaning one that allocates all usage rights based upon who signs up, calls, emails or logs on first. These systems become frustrating over time, as well as unfair to those who do not have the time, inclination or expertise needed to master the system. There is nothing wrong with fractional ownership reservation systems that offer some usage on a "first-come-first-served" basis, provided that the system operates as a supplement to another system that allocates some usage to each owner on a non-competitive basis.

The third system to avoid is the “gambler’s” system, meaning one based entirely on chance (such as picking cards from a deck or drawing straws). The problem here is that the lucky owner who drew first choice the past three consecutive years has just as much chance of drawing first this year as the unlucky owner who has been last in each of these years. Each owner deserves the right to choose first just as often as each of the other owners, and a chance-based system almost guarantees that this will not occur.

Usage Variation 1: Using the Same Home Each Visit

Many fractional vacation arrangements involve more than one resort, house or condominium. Sometimes the homes are located in different places, and other times there are multiple homes at one location. In these arrangements, each fractional owner’s usage rights can be either “unit-specific”, where each owner uses the same home on each visit, or “non-unit-specific”, where the home an owner will use depends on the usage allocation system. In unit-specific fractionals, the owners entitled to use a particular home share the cost of repairing and maintaining only that home, while in non-unit-specific fractionals, the owners using a certain group of homes share the cost of repairing and maintaining all of the homes in that group. Here are some advantages and disadvantages of unit-specific usage:

Unit-Specific Usage

- Feels more like home, since you visit the same home each time
- Allows the group that shares the home to have more autonomy and control of decorating, repairs, budgeting and other issues
- Exchanges can provide variation of vacation home when desired

Non-Unit-Specific Usage

- Makes it more likely there will be space when you want to go
- Lowers maintenance costs by adding economies of scale
- Spreads risk of unforeseen maintenance problems among more people

When comparing usage allocation systems, take care not to confuse ownership with usage rights. In many multi-unit fractional developments with non-unit-specific usage, each participant is deeded a fraction of a particular condominium or home. In this arrangement, even though the owner visits the fractional development frequently, he/she may never use the condominium or home he/she owns. Conversely, there are situations where each owner a fraction of the entire multi-unit property, but always uses the same condominium or home.

Usage Variation 2: Coming The Same Time Each Year

“Fixed-Date” usage systems assign each owner days, weeks or months of usage that remain the same each year. More desirable usage (such as high season or school holidays) is usually priced higher to reflect the fact that more buyers want it. Here are some advantages and disadvantages of fixed-date usage:

Fixed-Date Usage

- Guarantees you will have the home at the times you are able to go
- Facilitates relationships among neighbors and allows extended families to more easily coordinate visits
- Allows some owners to save money by buying off-season dates
- Less expensive and simpler to operate than other systems (keeping owner dues lower)
- Exchanges can provide variation of vacation timing
- Can be combined with non-fixed-date usage to allow some owners to have all fixed usage and others to have variety, or to allow each owner both fixed usage and variety

Non- Fixed-Date Usage

- Lowers cost of high season usage by allowing more owners to share it
- Allows greater variety and flexibility of usage
- Eliminates risk that life changes will make assigned period unusable
- Eliminates potential difficulty of finding owners willing to purchase undesirable usage periods

Usage Variation 3: Fixed Rotation Plans and Usage Reservation Systems

A “fixed rotation plan” ensures that, over a period of years, each owner will be entitled to use the property during each day of the year. For example, a simple fixed rotation plan for eight fractional owners assigns each owner every eighth week, and starts the rotation with a different owner each year, so that each owner will have rotated through every week over the course of eight years. More complex fixed rotation plans can vary the length of usage periods (so that, for example, owners use the property for some two-week periods and some one-week periods), or group certain premium periods or holidays together (so that, for example, each owner gets at least a certain number of highly-desirable weeks or days every year).

A “usage reservation system” allows owners to reserve usage based on availability and a system of rules. An example of a simple usage reservation system for eight fractional owners would be where, during October of each year, each owner selects usage for the following year based on a rotating system of priority. The owner with first choice in a particular year might choose two weeks, followed by the owner with second choice, and so on. After each owner had selected two weeks, the process would begin again in reverse order. Finally, in a third round of selection, each owner would choose his/her fifth and sixth week.

Larger fractional ownership developments tend to have more complex usage reservation systems that combine a limited amount of advance reservation with “unlimited” shorter-notice usage. For example, a private residence club with eight fractional owners per home might allow each owner to reserve three weeks of usage per year in advance based on a rotating system of priority, which would leave 28 weeks unreserved. At the close of the advance reservation window, the 28 unreserved weeks become available on a first-come-first-served basis, with restrictions on how far in advance such reservations can be made, and on how many reservations can be held by each owner. When this type of reservation program is combined with non-unit-specific usage, owners with the flexibility to vacation on short notice are likely to be able to visit the property far more frequently than with other systems.

In comparing fixed rotation plans to usage reservation systems, consider the following advantages and disadvantages:

Fixed Rotation Plans

- Allows vacations and events to be planned years in advance
- Very early advance knowledge facilitates exchanges with other owners before they have made plans
- Less expensive and simpler to operate than usage reservation systems (keeping owner dues lower)

Usage Reservation Systems (simple--with entire year reserved in advance)

- Provides flexibility for owners to adapt to tailor each year’s usage without relying on owner exchanges
- Less expensive and simpler to operate than complex usage reservation systems

Usage Reservation Systems (complex--with part of year reserved in advance and “unlimited” short-notice usage)

- Offers extra usage and last-minute getaways for owners with flexible schedules

Fractional Ownership Exchange Programs

In the context of fractional ownership, an exchange is a transaction where one fractional owner exchanges usage rights with another. Exchanges can be “informal”, where fractional owners arrange the exchange themselves, or “organized”, where the exchanging owners subscribe to an exchange program that facilitates finding exchange opportunities and coordinating the exchange transaction. There are “internal” exchanges, where fractional owners of the same home or within the same development exchange with one other, and “external” exchanges, where fractional owners in different and unrelated properties exchange.

Informal internal exchanges, where one fractional owner informally exchanges usage rights with another fractional owner of the same property, are common in all fractional vacation ownership arrangements. These exchanges can be facilitated by a property manager or on a website, or simply arranged by the exchanging owners via email or telephone. Informal internal exchanges are useful for adding flexibility to fixed-date usage and fixed rotation plans without the added operating costs of a usage reservation system.

Informal external exchanges, where a fractional owner informally exchanges with the owner of a distant property, are generally restricted to fractionals that allow rentals. A variation is where a fractional owner exchanges with someone who owns an entire vacation home elsewhere. Informal external exchanges are becoming more common as websites and agencies

to facilitate such exchanges are created. Nevertheless, these exchanges can be complicated by the difficulty in agreeing on the value of the properties to be exchanged, and by the need to coordinate scheduling.

Organized exchange programs, both internal and external, are extremely popular among fractional buyers and are often mentioned as one of the most important factors in the selection of one fractional property over another. Internal exchange programs are operated by the management teams of most multi-unit fractional developments, while external exchange programs are offered both by developers that operate fractional projects at multiple locations, such as Timbers, Ritz Carlton, and Hyatt, and by independent exchange companies, such as RCI, Resort To Resort, and Registry Collection. Many independent exchange companies accept individual fractionally-owned homes as well as fractional developments.

Most organized exchange programs operate on a point system under which the operator assigns points to each property based on location, size, amenities and demand. For homes in seasonal locations, the points assigned to a particular home may vary based on the time of year when usage is offered for exchange. Owners wishing to exchange place usage rights on offer, and receive points if another participant in the exchange program reserves the usage. Owners with points can then use them to reserve other properties. The program operator facilitates all aspects of the exchange. In developer-operated exchange programs, the cost of the program is often included in the owner dues. Independent exchange companies generally charge an initiation fee (that includes the cost of visiting the property to determine the number of points to be assigned), annual fees, and per-transaction fees.

In assessing the value and importance of an exchange program, it is important to look beyond the glossy brochure displaying the fabulous properties on offer throughout the world. The fact that a certain property is part of the exchange program does not guarantee that you will be able to use it. Many participants in exchange programs complain that they have never successfully reserved an exchange they want, even after 4-5 years of trying and waiting. Your ability to exchange for a property you wish to visit will depend on four factors: (i) the demand of other owners for the property you own; (ii) the frequency with which the owners of the property you want to visit offer their usage for exchange; (iii) the amount of competition from other exchange program participants for the property you want to visit; and (iv) the relationship between the number of points you earn when someone reserves your property and the number of points you need to use the property you want to visit.

The only way to meaningfully evaluate an exchange program is to demand answers to questions that are not addressed in the glossy brochure. When owners of the property you are considering purchasing have offered their usage for exchange, how often (by percentage) have others reserved the usage? Assuming someone reserves usage you offer for exchange, how many points will you receive? How many points are needed to reserve each of the five exchange properties you are most likely to want to visit? For each of these five properties, how much usage was placed in the exchange program the previous year, and how much of that was reserved? On average, how long has it taken to get a reservation in each of your five likely target properties? If you cannot get satisfactory and reliable answers to these questions, reconsider the amount of importance you give to the availability of the exchange program.

Also keep in mind that exchange programs change over time. These can include new program rules that make exchanging less attractive or more difficult, changes in the number or type of properties in the system, more owners competing for exchange opportunities, a decrease in the point value of your property relative to others, or even the cancellation or replacement of the entire exchange program. For this reason, it is important not to over-emphasize the importance of exchange programs in the purchase decision, and to make sure you choose your fractional based on the property you are buying rather than on potential exchanges. Also consider that the ability to do your own informal external exchanges is good insurance against future deterioration in the organized exchange program, and you may regret buying into a fractional that prohibits such exchanges.

Fractional Vacation Activities and Services

The key to evaluating and comparing activities and services (the “recreation amenities”) is understanding how each affects cost, and then deciding whether the cost is justified by the benefits. On the cost side, each amenity impacts both purchase price and owner dues, and the future cost of operating certain activities, or providing certain services, varies depending on the type of activity or service. In other words, some recreation amenities create more risk than others because their impact on your dues is less predictable. On the benefits side, each amenity will affect your enjoyment, the potential for exchanges and rental income, and the future value of your fractional interest, and each of these potential benefits should be considered. Also consider which amenities are more susceptible to devaluation as a result of poor maintenance or management.

One good rule of thumb in weighing the cost and benefits of a recreation amenity is that a natural or public activity or service is usually a better value than a private or property-specific one. Natural/public amenities include beaches, lakes, mountains, public golf courses, and local health clubs, while private/property-specific ones include on-site pools, private spas, and concierges. While both impact price, the latter have a much greater affect on future costs, and are more susceptible to devaluation over time due to poor maintenance or management. Of course, this favorable aspect of natural/public amenities must be weighed against the lack of exclusivity. Also remember that the value of a natural/public activity or services is directly related to its proximity to your property, and the value drops off sharply if you need to use a car to reach it.

A useful principal for weighing the cost and benefits of a private/property-specific recreation amenity is that infrastructure-based ones are usually a better value than people-based ones. Infrastructure-based amenities include private pools, private health clubs, and private tennis courts, while people-based ones include private spas, on-site restaurants, doormen, and concierges. While both infrastructure-based and people-based amenities will affect owner dues, the future cost of providing people-based ones is less predictable, and more susceptible to a drop-off in quality over time. The more people-based amenities a fractional ownership development has, the more prone it is to sharp dues increases and deterioration in quality.

Another useful principal for evaluating a private/property-specific recreation amenity is that those provided on a pay-per-use basis are generally a better value than those provided at no additional charge. Most people incorrectly assume that a free activity or service is a bargain, and bristle at the idea of having to pay each time they want to use it. But it costs money to maintain and provide each amenity, and the real difference between pay-per-use and “free” is whether the cost is paid only by the people who use the amenity, or shared by those than do not. This aspect of a “free” amenity will seem attractive if you anticipate using it often, but remember that most people do not use private/property-specific recreation amenities as often as they expect, and that usage tends to diminish over time. More important, the ongoing need to entice visitors to use a pay-per-use activity or service creates an incentive for management to keep quality high and operating costs low.

Fractional Owner Group Size and Context Within Larger Development

Larger fractional ownership groups are best if you prefer more anonymity, less responsibility, and the security offered by a larger and presumable well-funded association. Larger groups also benefit from certain economies of scale, which generally lower management and operating costs, but these benefits can be compromised by inefficiency and the need for some larger associations to generate a management profit. Smaller groups are best if you prefer a personal relationship with your co-owners, greater involvement in decision-making, and more control over costs. The fact that a fractional owner group is small does not mean that it must or should be operated informally or haphazardly, or that the fractional owners must devote time to personally managing the property; in fact, most small fractional owner groups have formal budgeting and assessment procedures, and outside professional management.

The relationship of the fractional owners or their property to a larger owners association or real estate development is a separate and independent variable from group size. There are many small fractional owner groups that own a single home or condominium within a larger development, and share a pool, golf course or private beach with the other owners in that development, even though none of the other homes or condominiums there are owned fractionally. On the other hand, there are many large fractional owner groups that own and share multiple homes at different locations, even though each home is a completely separate, stand-alone single family residence that is not part of a larger housing or resort development. The context of the fractionally-owned property within a larger development affects the usage experience rather than the ownership experience. A stand-alone home is best if you prefer privacy and exclusivity. A home or condominium located within a larger housing or resort development is best if you prefer to be near other vacationers, and want more on-site amenities and services.

Fractional Developer Experience and Branding

The involvement of an experienced and well-known developer or hotel operator in a fractional ownership offering provides some assurance of the quality of the property and its management both at the time of purchase and in the future, and also increases the likelihood that the fractional property will hold its value or appreciate. Choosing a famous-name fractional can also be a lifestyle choice for those that value the image the brand represents. But brand-name fractional real estate products cost more than other fractional ownership options, and it is important to weight the added costs against the benefits.

Recent events illustrate how established and seemingly prosperous companies can suddenly fail. Moreover, hotel and resort brands considered the ultimate in luxury just 20 years ago have since been eclipsed by newer brands, and the names that

represent luxury today are likely to be seen as mediocre 10 years from now. Finally, keep in mind that name brand hotel and resort operators often change personnel and focus, and there is no guarantee that the operator will not outsource management of your fractional property or try to position its newer development down the road as more desirable.

Non-Owner Usage and Rentals In Fractional Ownership

In some fractional ownership arrangements, owners are permitted to bring guests, but cannot allow guests to visit the property without the owner. Many owners value the ability to invite their family, friends and business associates to use the property when the owner is unable to do so. On the other hand, allowing unaccompanied visitors means more people can use the property, which diminishes the feeling of exclusivity, increases wear and tear, and creates more competition in some usage reservation systems.

A separate but related issue is the ability to advertise the property for rent. The ability to earn rental income is an obvious benefit for fractional owners who do not expect to use all of their usage allotment. Even if you expect to use all of your time, consider that your desires, priorities or life situation may change, and the prospect of rental income may become more attractive. The downsides of allowing rentals are similar to those of allowing unaccompanied visitors: less exclusivity, more wear and tear and, in some usage allocation systems, more competition for usage. Some believe that rental tenants cause more property damage than unaccompanied friends or family, but no evidence supports this viewpoint.

If unaccompanied guests and/or rentals are permitted, make sure the fractional ownership contract places ultimate responsibility for damage or loss caused by the guests or tenants on the owner who invited the guest or received the rent. Requiring damage deposits is fine, so long as any cost not covered by the deposit is paid by the inviting/renting owner. It should never fall to the other owners or the association to pay for the loss or to try to recover from the tenant or guest. It is best if the agreement requires all advertised rentals to be arranged through a specific, association-designated management company or rental agency. This requirement ensures uniformity in tenant screening, orientation, and supervision. The owner who offers his/her time for rent pays the fees and commissions charged by the rental agency, and retains the balance of the rent. Pooling of rent, where income is shared by fractional owners, should be avoided unless the system takes the usage pattern of each owner into account when determining how rental income is allocated.

Owner Control In Fractional Ownership

Perhaps the most commonly overlooked and misunderstood issue in fractional real estate is the balance between delegating day-to-day management functions and reserving ultimate control over operations and costs. In general, owners drawn to smaller, less formal fractional vacation ownership arrangements tend towards delegating too little, while owners drawn to large developments tend towards delegating too much. The best approach is to fully delegate day-to-day management and decision-making authority to a manager or resort operator while maintaining owner power to approve budgets and periodically replace management. This basic principal applies when four family members or friends form their own fractional ownership group, and when Ritz Carlton develops, sells and operates a 350-unit resort.

Many owners in small fractional vacation ownership groups assume that having any sort of manager is unnecessarily formal, and believe that all the owners can informally share the management tasks. Often, the result of this informality is an unfair division of labor, a shared vacation home that becomes "tired" over time, and "vacations" that include maintenance work on the shared home. A better approach for small groups is to delegate budgeting, accounting, repairs, periodic replacement of furnishings, and other routine management functions to one of the owners or to a small off-site property manager. Budget approval, major spending, management changes, and other non-routine decisions are reserved for the owners.

Many owners in large fractional developments have no interest in being involved in operations, and fear that allowing other owners to be involved will invite infighting, paralysis, and general mismanagement. These owners mistakenly assume that giving total control to a developer or resort operator is the best way to avoid their own involvement and prevent involvement of other fractional owners. In fact, giving up ultimate control, even to a highly reputable and famous-name resort operator, is risky. Experience has shown that the interests of resort operators diverge from those of owners over time. The resort operator's motivation to keep quality at the fractional property high, and owner dues reasonable, diminishes after the property is sold out, and this tendency is magnified if the owners do not have the power to replace management. In theory, the resort operator works to preserve the company name so that future projects sold under that name will command higher prices. But in practice, the linkage between management of older developments, company reputation, and the pricing that can be commanded for newer projects marketed under the same brand, is not always strong enough to motivate the operator to

maintain high quality and control owner costs. Moreover, when economic conditions are poor, management fees from older developments may become a primary revenue source, creating pressure to raise owner dues, particularly if the owners have no say in setting the dues or replacing the operator. No matter how rock-solid and prestigious the developer's reputation, make sure that the fractional ownership governing documents reserve ultimate control of budgets, dues, and management replacement to a board of directors elected by the owners.

Fractional Ownership Resale and Exit Opportunities

While most fractional real estate buyers are concerned about the resale potential of their fractional property, many mistakenly focus only on resale value and ignore the potential barriers to resale within the fractional ownership contract. Resale value is irrelevant if you are unable to sell when you need or want to sell.

In small fractional ownership groups, resale barriers are often deceptively simple. One common provision is a "right of first refusal", where a reselling owner must first offer his/her share to others. A poorly drafted right of first refusal can have consequences that are unintended and/or unexpected. For example, if the right to purchase is based on an appraised value, the seller almost always receives less than the true market value of his/her interest because appraisals are almost always low, particularly for fractional real estate interests. A poorly drafted right of first refusal can also prevent a gift or discount sale to a family member. Other restrictions, such as a requirement to get group approval before selling, can be equally troublesome. Participants in even the smallest, least formal, and most congenial groups need to remember that their health, job, residence, family situation, lifestyle or taste will change in unexpected ways, and that needing or wanting to exit the fractional ownership group is a real possibility.

In larger fractional ownership arrangements, resale barriers tend to be more obvious. The most common are:

- Timing Restrictions, which prohibit resale within a certain number of years after purchase, restrict resale while the developer is still selling, or allow only a certain number of sales per year;
- Marketing Restrictions, which require the reselling owner to offer the property only through the developer and pay a pre-set sales commission; and
- Pricing Restrictions, which impose minimum pricing requirements in order to maintain the property values within the development and prevent a reseller from undercutting the developer's price.

Potential exit barriers also exist in destination clubs and vacation clubs with guaranteed buyback provisions. Some clubs limit the number of owners that can exit the club each year, or tie exit to the number of new members entering the club. These restrictions can be problematic if the club is in financial trouble and everyone decides to get out at once. More generally, any refund right is only valuable if the club can afford to pay it. For this reason, equity destination and vacation clubs, where the homes are owned by the members, are less risky than non-equity-based clubs.

Fractional Ownership Contracts, Agreements and Documents

The governing documents are the most important element for minimizing risk and ensuring long-term enjoyment of fractional vacation ownership. After the sales staff is long gone and everything they told the buyers is forgotten, after the crack startup management team is replaced, and after the co-owners who swore they would never sell move on, the contract will endure and be the final arbiter of how the fractional ownership arrangement operates.

Here are the most critical elements of any fractional ownership document set, in order of descending importance:

- Usage: How is usage of the fractional property allocated? Is the system fair (meaning it cannot be "gamed" by someone with special knowledge or connections) and transparent (meaning owners can verify that any computer system or human manager is following the usage allocation rules)? Can your usage rights can be diluted or changed against your will by a resort operator, board or owner vote?
- Owner Dues/Fees: How is the budget established and approved, how are owner dues set, and do owners have a say? Can your percentage of costs be increased against your will by a resort operator, board or owner vote?
- Management/Owner Control: Will there always be an identifiable individual or company responsible for operating the property, and do the owners retain final control over replacement of management?
- Enforcement: Is there a reasonably quick and cost efficient way to enforce the documents, collect owner dues, and, if necessary, force an owner out, without a court procedure?

- Replacement Reserves: Will owner dues include adequate reserves to periodically repair and replace all of the items that make the property desirable, including furniture, bedding, appliances, electronics, kitchen and tableware and other items?
- Developer/Seller Dues Obligations: When does the developer/seller start to pay dues on unsold shares, and how will expenses be paid before then?
- Resale: When and how can you resell, and what restrictions will apply?
- Unaccompanied Guests and Rental: What restrictions apply to unaccompanied guest and rentals, and who is responsible for damage or loss to the property?

Too many fractional ownership agreements fail to strike the correct balance between completeness and understandability. The short and simple agreement is mostly useless because the problems that fractional owners experience in real life are never the ones they expect. At the other extreme, the 140-page, jargon-filled document set used by some large developers often serves as a hiding place for the provisions the seller does not want you to see, or contains so many contradictory and ambiguous clauses that it resolves nothing. Never buy fractional real estate, even from the most reputable developer, without reading and understanding all the governing documents. If you cannot understand the documents, find someone (not associated with the sale) to help. If you are comparing two fractional ownership opportunities that seem equally desirable, choose the one with the documents that seem most clear and most complete.

ABOUT THE AUTHOR

Andy Sirkin has focused on fractional real estate projects since 1985, and has been involved in the creation of more than 5,000 fractional projects throughout the United States, as well as Europe, and Central and South America, ranging in size from a single house or condominium up to hundreds of fractional interests. This breadth of experience allows the firm to draw on a huge library of fractional project documentation as well as extensive knowledge of marketing and registration requirements for virtually any location where a project might be located or potentially marketed. Andy is the author of two books as well as numerous published articles, and has compiled a searchable disk containing the complete text and a summary of fractional ownership law for all 50 U.S. states. He has also created an extensive library of instructional material for fractional developers, brokers, and buyers, available at sirkinfractionallawyers.com. He is an accredited instructor with the California Department of Real Estate, and frequently conducts workshops and appears at conferences throughout the world. He currently splits his time between offices in Paris and San Francisco, and can be contacted via email at DASirkin@earthlink.net, or by phone at 33-1-7666-0202 (EU) or 1-415-738-8545 (US).