Sunrise Analysis: Destination Clubs

A Report to the Governor and the Legislature of the State of Hawai‘i

Report No. 08-01
January 2008

THE AUDITOR
STATE OF HAWAI‘I

Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawai‘i State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

Under its assigned missions, the office conducts the following types of examinations:

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3. *Sunset evaluations* evaluate new professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with criteria established by statute.

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THE AUDITOR

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OVERVIEW

Sunrise Analysis: Destination Clubs

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Summary

In Senate Concurrent Resolution No. 75, Senate Draft 1, the 2007 Legislature requested that the Auditor conduct a "sunrise" analysis of Senate Bill No. 697, which proposes to regulate destination clubs. The Hawai'i Regulatory Licensing Reform Act (Chapter 26H, Hawai'i Revised Statutes) requires that legislative bills proposing regulation of previously unregulated professions or vocations be referred to the Auditor for sunrise analysis prior to enactment. The Auditor is to assess whether the proposed regulation is necessary to protect the health, safety, or welfare of consumers and is consistent with the regulatory policies in Chapter 26H, HRS. In addition, the Auditor is to examine the probable effects of the proposed regulation and assess alternative forms of regulation.

Destination clubs are a relatively recent, fast growing segment of the vacation market. There are eight destination clubs with properties in Hawai'i and an estimated 15 Hawai'i residents are club members. About 20 clubs offer their members luxury accommodations in multi-million dollar properties around the world. They are the primary choice of affluent households, particularly those with families who prefer to vacation in luxurious homes instead of hotels. Destination club services may include travel, private jets and yachts, concierges, housekeeping, and private chefs. Members who wish to join must pay initial membership deposits that range from $40,000 to $3,000,000 as well as annual fees. The amount of the initial deposits and the annual fees vary according to the number of days of planned usage and the quality and size of the vacation homes owned and offered by the club. For the most part, destination clubs are not an investment. Members receive no equity in most clubs; instead, they have a membership contract that gives them the right of access to a portfolio of properties owned or leased by the club. Club memberships cannot be sold or traded. All clubs allow members to resign as they wish and receive a refund of their membership deposits that range from 80 percent to 100 percent.

In January 2004, an advertisement for the destination club Exclusive Resorts triggered an investigation by the Regulated Industries Complaints Office (RICO) of the Department of Commerce and Consumer Affairs to determine if Exclusive Resorts was operating as an unlicensed real estate broker under Chapter 514E, HRS. Later that year, a civil action was filed in the Hawai'i Third Circuit Court to prohibit and enjoin Exclusive Resorts from any commercial or time share activities in the Pauoa Bay Subdivision on the Big Island. A similar complaint was filed in U.S. District Court.

In July 2005, the Third Circuit Court declared that Chapter 514E, HRS, did not apply to Exclusive Resorts' plans to use its Pauoa property for club members. The judge ruled that the planned use was not a "time share ownership plan" because the

members have no ownership interest in the accommodations. In August 2005, the U.S. District Court concurred with the state court that Hawai'i's time share law did not apply.

These decisions notwithstanding, DCCA maintains that destination clubs may be regulated under the state's time share law. In November 2006, Exclusive Resorts signed an Agreement of Voluntary Compliance with the department. The agreement lapsed as of May 2007. During the interim, several destination clubs formed the Destination Club Association to promote responsible business practices. The department convened a working group composed of destination club and time share industry representatives to develop new regulations. Senate Bill No. 697 is the resulting bill. The department has taken no further action against Exclusive Resorts pending the outcome of the bill.

We believe that Senate Bill No. 697 should not be enacted because it does not meet sunrise criteria requiring evidence of abuse. The bill is an unnecessary regulatory measure that would add little consumer protection. We also conclude that destination clubs should not be regulated under the State's Time Sharing Plan law since the provisions in the law are inappropriate for regulating their operations. The time share law was enacted to prevent rampant abuses early in the industry. These abuses are not characteristic of the operations of destination clubs. If the department chooses to enforce Chapter 514E, HRS, it would have to do so piecemeal as major provisions would have to be waived or modified. Finally, no other states regulate destination clubs under their time share laws.

Recommendations and Response

We recommend that:

1. The Legislature not enact Senate Bill No. 697, 2007 Regular Session.

2. The Department of Commerce and Consumer Affairs close its investigation of Exclusive Resorts and issue a no action letter regarding its regulation under the Chapter 514E, HRS, the *Time Sharing Plan* law.

The Department of Commerce and Consumer Affairs agrees that Senate Bill No. 697 is imperfect but believes that some type of regulation is needed to protect consumers, other than Chapter 514E, HRS. Nevertheless, the department presents no new evidence of consumer harm in the destination club industry or abuse similar to those found in the time share industry.

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Sunrise Analysis: Destination Clubs

A Report to the Governor and the Legislature of the State of Hawai‘i

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Submitted by

THE AUDITOR
STATE OF HAWAI‘I

Report No. 08-01
January 2008

Foreword

This “sunrise” report on destination clubs was prepared in response to a provision in the Hawai‘i Regulatory Licensing Reform Act, Chapter 26H, Hawai‘i Revised Statutes, that requires the Auditor to evaluate proposals to regulate previously unregulated professions or vocations.

In Senate Concurrent Resolution No. 75, Senate Draft 1, of the 2007 legislative session, the Legislature requested an analysis of Senate Bill No. 697 that proposes to regulate destination clubs. This evaluation, conducted by Diana M. Chang, consultant, presents our findings and recommendation on whether the proposed regulation complies with policies in the licensing reform law and whether a reasonable need exists to regulate destination clubs to protect the health, safety, or welfare of the public.

We wish to express our appreciation to the Department of Commerce and Consumer Affairs and other organizations and individuals that we contacted during the course of the evaluation.

Marion M. Higa
State Auditor

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Chapter 1

Introduction

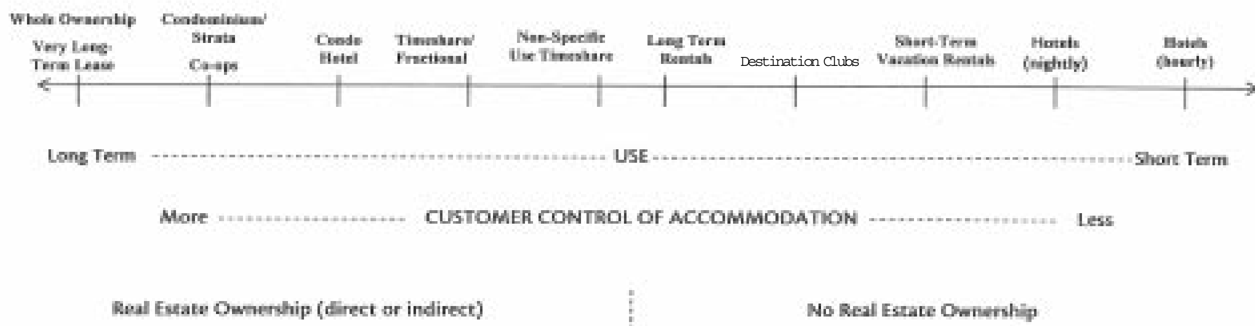
Introduction

This report responds to Senate Concurrent Resolution No. 75, Senate Draft 1, of the 2007 legislative session requesting a "sunrise" analysis of Senate Bill No. 697 that proposes to regulate destination clubs. The Hawai'i Regulatory Licensing Reform Act, Chapter 26H, Hawai'i Revised Statutes (HRS), requires that, prior to enactment, legislative bills proposing regulation of previously unregulated professions or vocations be referred to the State Auditor for sunrise analysis. The State Auditor is to assess whether the proposed regulation is necessary to protect the health, safety, or welfare of consumers and is consistent with the regulatory policies in Chapter 26H, HRS. In addition, the State Auditor is to examine the probable effects of the proposed regulation and assess alternative forms of regulation.

Background

The vacation home market has become increasingly diverse to attract different segments of the leisure travel industry. Exhibit 1.1 shows the range of vacation options from long-term to short-term use and from complete, second home ownership to no real estate ownership. Owners of a second vacation home have the greatest control over their vacation plans, while hotel and resort guests have the least control. The new destination club option sits at the middle of the spectrum. Most destination clubs do not offer property ownership but do promise access to some priority resort areas during peak periods.

Exhibit 1.1
Hospitality Spectrum



Source: Destination Club Association Presentation, July 2007.

The lines among these vacation options are not clear-cut. Time shares and fractionals (which include residence clubs) are similar in that they involve shared ownership in a specific vacation property. They are usually deeded and can be bought, sold, and transferred.

Time shares are the least expensive ownership vacation option, and costs typically range from about $10,000 to $50,000 for a week of use. The number of owners of a time share unit may range from two to 50. Fractionals are more expensive, luxurious, offer more amenities, and have fewer owners per residence. Prices range from $250,000 to $300,000 for three to four weeks of use. They operate more like second vacation homes without the headaches of maintenance.

Residence clubs are even more luxurious versions of fractionals that offer such amenities as concierge and housekeeping services.[1] Hotels such as Ritz-Carlton, Fairmont, and Four Seasons now offer residence club purchases. They, like time shares, offer fractional ownership in a specific real estate property. Owners of private residence clubs receive a title and deed. For example, a buyer may purchase a month of a particular property owned by Ritz-Carlton and receive a deed for one-twelfth interest in that property. The purchaser may trade a portion of the allotted number of vacation days for vacations at other Ritz-Carlton properties.

The Hawai‘i Department of Commerce and Consumer Affairs (DCCA) has been regulating time shares since 1980 when Hawai‘i enacted Chapter 514E, HRS, on *Time Sharing Plans*. The department also regulates fractional plans and residence clubs under the same time share law. However, it does not regulate destination clubs—the focus of this report.

Destination Clubs

Destination clubs are a relatively recent vacation option targeted at the luxury market. They are the fastest growing segment of the vacation market and a top choice of affluent households, particularly those with families who prefer to vacation in luxurious homes instead of luxury hotels. Destination clubs estimate that their members have an income of several million dollars a year.

The concept originated in 1998 with a company that entered into a licensing agreement with the established, upscale, travel operator Abercrombie and Kent. It became known as A&K Destinations and subsequently changed its name to Tanner & Haley. It declared bankruptcy and was acquired by Ultimate Resort in 2006.[2] The concept,

however, has attracted investors to the industry. Today, more than 20 destination clubs with about 5,000 members operate approximately 700 luxury properties worldwide.[3]

Destination clubs are structured like exclusive country club memberships. They offer *access* to multi-million dollar residences in multiple locations. For an initial membership deposit and annual dues, members share usage and have the right of access to a portfolio of fully furnished, luxury homes as well as travel and concierge services. The multi-million dollar homes range from 2,000 to 6,000 square feet and typically have top of the line furnishings, gourmet kitchens, and high-end audio/video equipment.

Generally, destination clubs are not an investment for members. Members receive no equity in most clubs. Instead, they have a membership contract that gives them the right to use a portfolio of properties owned or leased by the club. Most clubs offer a refund of 80 percent of the initial membership deposit should a member choose to resign. Some, such as the LUSSO Collection, Solstice Collection, and Ciel will refund 100 percent of the initial deposit. The largest clubs are said to have sufficient capital to fund growth and provide refunds to members who resign.

Destination clubs are offered to luxury travelers as a cost-effective alternative to second homes, five-star hotels, and other high-end vacation options. The initial membership deposits are typically lower than the down payment for a comparable luxury vacation home. The annual dues are less than the total annual costs of maintaining a comparable second home. In addition, destination clubs offer very high levels of predictable accommodations and services including travel arrangements, private jets and yachts, concierges, housekeeping, and private chefs. They offer the comfort and spaciousness of a private home together with the amenities of a five-star resort.

Analysis on a cost-per-night basis shows that destination clubs are generally a less expensive alternative to staying at luxury hotels or resorts. As an example, a member who pays a membership deposit of $395,000 and annual dues of $25,000 for 60 nights of accommodations can receive a refund of 80 percent, or $316,000, when the member cancels after ten years. The member would have paid almost $33,000 per year but with 60 days of use, the cost is just under $550 per night.[4] In comparison, the cost for a three-bedroom suite at a luxury resort may be as much as $5,000 per night during peak season.[5]

Profile of destination clubs

Currently, prospective members have a choice of over 20 destination clubs that offer accommodations worldwide. Most clubs were

established within the past four years, with about five recently launched. Eight of these clubs have vacation properties in Hawai'i. Information about destination clubs is readily available on two web-based services: the Sherpa Report and Helium Report. The Sherpa Report's *Guide to Destination Clubs* categorizes clubs into four tiers based on the initial fee, the average home values, and the cost per night as follows:[6]

- **Elite**: These high-end clubs offer homes with an average value of $5 million to $10 million and charge initial membership fees of $0.5 million to $3 million. Such clubs may provide private jets, personal chefs, and butlers to their members as part of their standard membership plan.

- **Super Luxury**: Premium clubs offer homes with an average value of $2.5 million to $5 million and charge initial membership fees of $185,000 to $750,000.

- **Luxury**: These clubs offer homes with an average value of $1.5 million to $2.5 million and charge initial membership fees of $125,000 to $404,000.

- **Entry:** Entry clubs offer homes with an average value of $750,000 to $1.5 million and charge initial membership fees of $30,000 to $150,000.

Exhibit 1.2 lists selected destination clubs, annual fees, the value of the homes offered to members, and whether the fees are refundable. Some offer refunds based on the current cost of the membership. Some of the clubs also offer equity in the club's real estate assets.

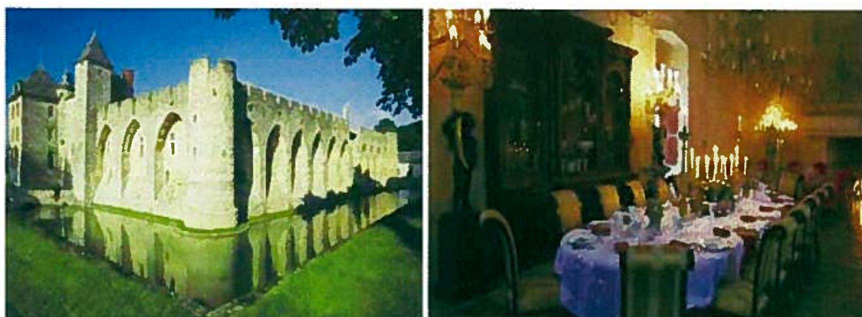
Exhibit 1.2
Destination Club Homes and Membership Fees

Club	Home Value (millions)	Initial Deposit	Annual Fee	Refund Policy
Elite	**($5m-$10m)**			
Yellowstone Club World	$10m	$3,000,000	$75,000	100%
Solstice Collection	$6.5m	$1,950,000	$86,000	100%
Ciel Club	$7.5m	$1,000,000	$100,000	100%
Super Luxury	**($2.5m-$5m)**			
Crescendo	$2.8m	$350,000	$23,500	Equity
Exclusive Resorts	$3.0m	$459,000	$34,900	80%
LUSSO Collection	$3.5m	$395,000	$28,000	100% + 50% apprec.
Protofino*	$3.5m	$395,000	$30,000	80%
Private Escapes*	$3.0m	$325,000	$22,000	80%
Quintess	$4.0m	$410,000	$27,500	varies
Ultimate Resort*	$3.0m	$350,000	$30,000	80% current value
Luxury	**($1.5m-$2.5m)**			
BelleHavens	$2.0m	$425,000	$33,500	90% current value
The Markers Club	$2.0m	$285,000	$16,500	90% current value
Entry	**($0.75m-$1.5m)**			
Gentry Retreats	$0.8m	$80,000	$6,000	100%
High Country Club	$0.8m	$50,000	$8,400	80%

*Offers multiple memberships. Only the most expensive level shown.

Source: Sherpa Report, Destination Clubs: A Guide for Prospective Members, June 2007, www.sherpareport.com, “Compare Destination Clubs,” December 11, 2007.

Exclusive Resorts, Paris. *Photograph courtesy of Exclusive Resorts website.*



Yellowstone Club World, France. *Photographs courtesy of Yellowstone Club World website.*

LUSSO Collection, Deer Valley. *Photograph courtesy of LUSSO Collection website.*

Solstice Yacht. *Photographs courtesy of Helium Report website.*

Types of destination clubs

The business models for destination clubs range from simple club membership to equity membership offering members the opportunity to buy into the entity that owns the club's real estate. Some hybrid clubs offer features that enable members to share in the appreciation on the initial deposit.

The higher end clubs, such as Yellowstone, Quintess, and Exclusive Resorts, are pure non-equity membership clubs similar to golf or health club memberships. Members are not shareholders in the club and do not receive any profits or interests in the appreciation of the club's real property assets. Members in a non-equity club merely have the right of access to the club's portfolio of properties.

Exclusive Resorts, Kohala Coast. *Photograph courtesy of Exclusive Resorts website.*

In non-equity clubs, which are usually limited liability corporations (LLCs), investors own the assets. Club operators use membership deposits to purchase luxury properties, in effect, using the monies as interest-free loans. They derive their profits from the non-refundable portion of the deposit, annual dues, and the potential appreciation in the real estate portfolio. Investors may also use debt funding or annual dues to purchase and operate properties.

At the other end of the spectrum, equity clubs, such as BelleHavens, offer equity in the club's real estate portfolio, that is, the members own a share in the limited liability corporation or entity that owns the club and its properties. One destination club, Crescendo, is set up as a real estate investment trust where members participate in any potential property appreciation. It is a registered security that complies with federal securities laws. Since members are issued shares in the club, federal law requires them to be "accredited investors" who are qualified to assess the risks of investment.[7] This means that members must have an individual or joint net worth that exceeds $1 million at the time of the purchase, must receive annual income exceeding $200,000, or must receive a joint annual income of $300,000 in each of the past two years and have a reasonable expectation of the same level of income in the current year.

Membership plans

Membership plans are aimed at generating capital from member deposits to purchase real estate. Members who wish to join must pay an initial membership deposit as well as annual fees. Some clubs may also charge an initial transfer and service fee in addition to the deposit. Total membership fees were estimated to be over $1.0 billion in 2005.[8] Generally, the size of the deposit, ranging from $40,000 to $3,000,000, corresponds to the quality and size of the vacation home available to the member. For example, the membership deposit for Yellowstone Club, an elite, invitation-only club, is $3 million. The average value of homes offered by Yellowstone Club ranges from $5 million to $10 million.

Exclusive Resorts, largely owned and chaired by Steve Case, co-founder of America Online, has about 65 percent of the destination club market with over 300 properties worldwide and over 2500 members. It has a real estate portfolio exceeding $850 million. Exclusive Resorts recently increased its fees for elite membership. As of August 2007, Exclusive Resorts charges an initial deposit of $459,000 and annual dues of $34,900 for 45 days of access. Affiliate membership is available for an initial deposit of $239,000 and annual dues of $13,900 for 15 days of access to the club's portfolio of properties. Exclusive Resorts will refund 80 percent of the initial deposit and provide financing for the deposit for up to five years.[9]

Club memberships cannot be sold or traded. All clubs allow members to resign as they wish and receive a refund of their membership deposit. Each club has its own refund policy. Promised refunds range from 80 percent to 100 percent of the deposit. Typically, clubs offer a three in, one out option where the member would receive a refund after three new members join. The ability of a club to refund the deposit depends on the amount of cash it has on hand and the number of new members who join. So far, none of the clubs are reported to be experiencing high numbers of resignations or having problems returning the deposits.[10]

Some clubs, such as Solstice, allow members to choose between a refund of either 100 percent of their initial deposit or 80 percent of the current price of a new membership. As competition has increased, some clubs are reducing their membership fees or offering trial memberships without an initial deposit. Some offer 100 percent refund of the deposit during the first year to allay concerns about "buyer's remorse."

The new One Key Destination Club has an innovative approach that emphasizes flexibility in terms of location and travel time. It does not charge the membership deposit that clubs typically use to acquire new properties. Instead, it uses an annual fee to support all its operations and to lease properties. Members can have 15 nights at a home for a fee of $34,900 and 25 nights for $49,900.[11]

Annual dues show a similar range. Prospective members can choose among several tiers of membership that vary according to the number of vacation days or quality of accommodations or services selected.

Tanner & Haley

The Tanner & Haley bankruptcy in 2006 surprised many. With 874 members, it was the second largest destination club at the time of its bankruptcy.[12] Members had paid deposits to join ranging from $85,000 to $1.3 million.[13] Because club management emphasized leasing rather than purchasing properties, it had only $130 million in real estate assets and about $400 million in debt when it filed for bankruptcy. In December 2006, Ultimate Resort acquired the assets of Tanner & Haley for $100 million. Members of Tanner & Haley were allowed to join the new club without paying any additional fees. Of the former 874 members, 650 have decided to join Ultimate Resort.

Emerging trends

Destination clubs are a new, rapidly expanding, and evolving vacation option. The industry is only about eight years old. On average, a new destination club has been launched each quarter since 2004.[14] At the same time, clubs are consolidating and evolving new business models. By consolidating, clubs can broaden their membership and increase their network of available homes. In 2006, Quintess merged with Dream

Catcher Resorts in a $62 million deal. Since then, Quintess has partnered with Leading Residences of the World, a subsidiary of Leading Hotels of the World, to create Quintess, Leading Residences of the World. Portofino Club has acquired Signature Destinations, and Crescendo has merged with Destination Private Resorts.[15] Recently, Ultimate Resort LLC and Private Escapes, the second and third largest destination clubs, announced that they planned to merge.[16]

Destination Club Association

In 2006, seven destination clubs came together to form a Destination Club Association. The purpose of the association is to create a governing body for the industry that could educate prospective members and clubs and establish best practices as fundamental operating principles for the industry.[17] The association has been instrumental in working with the State to develop a model act for regulating destination clubs. The list of members is shown in Exhibit 1.3.

Exhibit 1.3
Destination Club Association Membership

Name	Date Founded	Total No. Homes	No. Homes in Hawai‘i
BelleHavens	2004	11	1
Exclusive Resorts	2003	300+	18
High Country Club	2005	25	2
Private Escapes	2003	50	2
Quintess	2004	49	3
Solstice	2006	11	0
Ultimate Resort	2004	105	5

Source: Destination Club Association member information as of January 2007.

The Destination Club Association has agreed to adhere to best practice standards in four areas:

1. Comprehensive consumer disclosures. Prospective and current members would receive information that includes all club operations and rules, a complete description of use of accommodations and services, and a thorough explanation of the club’s resignation, termination, and membership refund policies.

2. Accurate, truthful, and appropriate marketing and sales practices that comply with all applicable laws and do not involve deceptive or coercive acts.

3. Financial responsibility through appropriate fiscal policies and practices that ensures adequate financial resources to meet a club's obligations for refunds and services, and internal policies that ensure financial oversight and fiscal accountability.

4. Responsible industry growth by educating consumers and others in the hospitality industry, building strong relationships with resort and vacation communities, committing to honoring all obligations and promises, and developing and adopting appropriate industry regulation to protect consumers and facilitate the responsible, long-term growth of the industry.

Impetus for Regulation

In January 2004, an advertisement for Exclusive Resorts was brought to the attention of the time share administrator at DCCA. It appeared that Exclusive Resorts was selling memberships that offered access to a portfolio of residences in Hawai‘i and around the world and entitled its members to stay at selected properties between 30 to 60 days a year. This triggered an investigation by DCCA's Regulated Industries Complaints Office (RICO) to determine if Exclusive Resorts was operating as an unlicensed real estate broker under the State's time share law, Chapter 514E, HRS. In May 2004, RICO informed Exclusive Resorts of its investigation and requested a written response.

Also, in May 2004, attorneys for certain owners in the Pauoa Beach Subdivision at Mauna Lani on the Big Island notified the developers and Exclusive Resorts that the owners were contemplating legal action for violating the specific prohibitions in the residential subdivision covenants against commercial or time share activity. In October 2004, certain owners of Pauoa Beach Subdivision filed a complaint in the Hawai‘i Third Circuit Court to prohibit and enjoin Exclusive Resorts from any and all commercial and time share activities in the subdivision. A parallel complaint was filed by two other owners in the Pauoa Beach Subdivision against Exclusive Resorts in federal U.S. District Court.

In February 2005, RICO notified attorneys for Exclusive Resorts that it intended to file a civil action against the company for operating and failing to register as a time share program in contravention of the State's time share law and for advertising violations under Chapter 436B, HRS. Exclusive Resorts then began negotiations with RICO on an Assurance of Voluntary Compliance.

In July 2005, the Hawai‘i Third Circuit Court declared that Chapter 514E, HRS, did not apply to Exclusive Resorts' plans to use its Pauoa Beach Subdivision properties for club members. In its order granting summary judgment for Exclusive Resorts, the Hawai‘i circuit

court judge ruled as a matter of law that Exclusive Resorts' program was not a "time share ownership plan" as defined in the State's time share law because its club members have no ownership interest in the accommodations. Neither is Exclusive Resorts' use by club members a "time share use plan" since members would not have fixed or vested rights to use the club's units for a specific or discernible period of time on a periodic basis. Moreover, it would be possible for a member to use a unit beyond the 60 days a year limit specified in the time share law. The circuit court also found that Exclusive Resorts' membership does not have characteristics of a unit of real estate since the membership is not associated with any specific designated real property, and properties in Exclusive Resorts' inventory can be included or removed at its discretion. In August 2005, the U.S. District Court concurred with the state court that Hawai'i's time share law did not apply to Exclusive Resorts' plans for its Pauoa Beach Subdivision property.

In September 2005, Exclusive Resorts requested that RICO close its investigation for several reasons, including the court rulings on the inapplicability of Hawai'i's time share law. Exclusive Resorts suggested that they work together to develop model legislation that would provide adequate consumer protections applicable to destination clubs. To develop an appropriate regulatory scheme for destination clubs, the department convened a working group consisting of representatives from the Destination Club Association and the American Resort Development Association (ARDA)—the time share industry professional association.

Senate Bill No. 697, of the 2007 legislative session, which proposes to regulate destination clubs, is the result of the efforts of the working group. It is an industry-backed bill supported by members of the Destination Clubs Association. During the 2007 legislative session, the Destination Clubs Association testified that the destination club industry is a new luxury vacation option that now includes more than a dozen clubs with over 640 residences in 50 locations worldwide, including 80 residences open or under development in Hawai'i. The association said that the clubs provide numerous economic benefits to the state by facilitating thousands of luxury vacations and infusing millions of dollars into the Hawai'i economy each year. It also said that the association has made an effort to identify key consumer protection and other business practices that are essential to prospective and current destination club members as well as the long-term success of the industry. Although many clubs have voluntarily adopted these standards, the association noted the importance of having a set of regulations that governs all destination clubs and ensures key consumer protections.

The Department of Commerce and Consumer Affairs testified that destination clubs provide consumers with a right to stay at various club

properties without conveying to them any ownership rights in the properties. The department felt that destination clubs fell within the definition of "time use plans" and were subject to Chapter 514E, HRS, on *Time Sharing Plans*.

Since Senate Bill No. 697 proposed a new regulatory program, the 2007 Legislature requested that the Auditor, in Senate Concurrent Resolution No. 75, Senate Draft 1, conduct a sunrise analysis of the proposal to regulate destination clubs and those who market them. Both the DCCA and the Destination Club Association supported the resolution.

Senate Bill No. 697, 2007 Regular Session

The proposed bill states that its purposes are to:

- Provide consumer protections and ensure responsible operations;
- Prohibit unregistered activity and require operators to register biennially with the director of Commerce and Consumer Affairs;
- Require full and fair disclosures to members and prospective members; and
- Establish financial responsibility requirements relating to club operators' financial obligations to club members.

The bill defines a destination club as a program where members pay a deposit and annual dues or other fees to receive the right to temporary use of accommodations and other club services. Members have no ownership interest in either the club operator or the operator's assets. The member or the club operator may terminate the membership at any time, subject to the terms of the membership agreement. The operator will refund the membership deposit upon the termination of membership in accordance with the terms of the agreement.

No person may sell or offer for sale membership to any person in Hawai‘i, offer to provide club services, or, hold oneself out as a destination club operator, without a valid registration.

Registration requirements

To become registered, a club operator would have to submit:

- An application that includes information about the club such as the operator's legal business name, mailing address, business location, the name of the destination clubs, full names and addresses of the club's five most senior executives and description of club services;

- A description of club services available at the location, number of accommodations available, and the number of members;
- A copy of the disclosure statement;
- Certification that the accommodations and nights of use are available to members;
- Certificates of compliance by the club operator;
- Statement of ownership and copies of the escrow agreement; and
- Payment of appropriate fees.

Disclosure requirements

To apply for renewal of the registration, each destination club operator would have to file a disclosure statement with the director of Commerce and Consumer Affairs. The statement must also be provided to prospective members. Among other provisions, the statement must include:

- The membership agreement;
- The type of membership being offered, the rights associated with the level of membership purchased, the destinations and number of accommodations available for temporary use, types of services offered, procedures and rules for reservations, the ratio of the actual number of accommodation nights promised to members to the number of nights available to members;
- A description of all payments due from members including the price of membership plans, annual dues or any additional dues;
- A description of the members' and club operators' termination rights;
- The process and requirements for members to obtain refunds of the membership deposits, including the number of members that have terminated their memberships, the maximum time that a member has waited for refunds, and the effect of bankruptcy on membership deposits;
- A statement that membership should not be viewed as an investment nor does membership constitute any ownership interest in real property or in the club operator, the destination or the accommodations or other club services; and

- Disclosures of any bankruptcy filings by the club operator.

In addition, each year, club operators would have to certify that they have the financial resources or assets to cover at least two-thirds of all membership deposits received and not refunded. This certification can be demonstrated through:

- The club's chief executive financial officer or chief financial officer certifying adherence to a net asset test that its net assets are in excess of membership deposits and debts; or

- Third party commitments such as commercial guarantees, insurance, letters of credit, or other irrevocable commitments by third parties to pay membership deposit refund obligations; or

- Other financial assurances acceptable to the director.

Club operators who cannot comply with the above certification requirements must notify their members.

Destination clubs cannot operate in any community, resort, or project in violation of land use or zoning restrictions that expressly prohibit transient or short-term accommodations of less than 30 consecutive days.

Senate Bill No. 697 also includes a list of prohibited acts such as misrepresentations regarding the club or advertising materials. The director may impose fines and issue temporary cease and desist orders for violations of the proposed law. The director may also inspect and audit books and records of any registered destination club operator.

Rescission rights

Prospective members may cancel their membership agreements before midnight of the seventh calendar date after the member signs the membership agreement or the date the disclosure statement is received. The cancellation is without penalty, and all payments must be refunded in whole on or before the fifteenth business day after the date on which the operator receives a notice of cancellation. The operator is to establish an escrow account with an independent escrow agent to protect any membership deposits made during the seven-day cancellation period.

Objectives

The objectives of this analysis were to:

1. Determine whether there is a reasonable need to regulate destination clubs to protect the health, safety, or welfare of the public.

2. Assess the probable effects of regulation, specifically the effects on destination clubs and their services.

3. Make recommendations, as appropriate, based on our findings.

Scope and Methodology

We applied the criteria set forth in Section 26H-2, HRS, of the Hawai‘i Regulatory Licensing Reform Act, to assess the need to regulate destination clubs as proposed in Senate Bill No. 697. These criteria seek to ensure that regulation occurs only when needed to protect consumers. Regulation is an exercise of the State's police power and should not be imposed lightly. Its primary purpose is not to benefit any industry or practitioners, who often seek regulation for reasons that go beyond consumer protection.

The consumer protection purposes of regulation are set forth in the policies in Section 26H-2, HRS. These policies state that:

- The State should regulate professions and vocations only where reasonably necessary to protect consumers;
- Regulation should protect the health, safety, and welfare of consumers and not the profession;
- Evidence of abuses should be given great weight in determining whether a reasonable need for regulation exists;
- Regulation should be avoided if it artificially increases the costs of goods and services to the consumer, unless the cost is exceeded by potential dangers to the consumer;
- Regulation should be eliminated when it has no further benefit to consumers;
- Regulation should not unreasonably restrict qualified persons from entering the profession; and
- Aggregate fees for regulation and licensure must not be less than the full costs of administering the program.

In assessing the need for Senate Bill No. 697, we placed the burden of proof on proponents of the measure to demonstrate the need for regulation. We sought documented evidence that the incidence or severity of harm is sufficiently real or serious to warrant regulation. We evaluated their arguments and data against the above criteria. We examined whether alternatives (such as federal programs, other state

laws, marketplace constraints, private action, or supervision) exist that could provide adequate protection. In accordance with sunrise criteria, even if regulation *may* have *some* benefits, we recommend regulation only if it is *demonstrably* necessary to protect the public. We scrutinized the appropriateness of the regulatory approach taken by the proposed legislation.

To accomplish the objectives of our analysis, we searched the literature on destination clubs including the development of the industry and its current status. We conducted interviews with representatives of destination clubs and ARDA, the time share industry association. We interviewed staff at the Department of Commerce and Consumer Affairs and reviewed files at RICO. We conducted our assessment from June 2007 to September 2007.

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Chapter 2

Regulation of Destination Clubs Is Not Necessary

This chapter presents our findings and recommendations on the need to regulate destination clubs. The criteria in Chapter 26H, Hawai‘i Revised Statutes (HRS), the Hawai‘i Regulatory Licensing Reform Act, warrant state regulation only when reasonably necessary to protect consumers. We found no evidence of abuse by destination club operators to meet the criteria for regulation. We conclude that Senate Bill No. 697, of the 2007 legislative session, is not necessary to protect consumers and should not be enacted. We also conclude that it would be inappropriate to regulate destination clubs as time share plans under the State’s *Time Sharing Plans* law, Chapter 514E, HRS.

Summary of Findings

1. Regulation of destination clubs is not warranted under the criteria for regulation in the Hawai‘i Regulatory Licensing Reform Act, and Senate Bill No. 697 should not be enacted.

2. The State should not regulate destination clubs under Chapter 514E, HRS, the *Time Sharing Plans* law.

Regulation of Destination Clubs Is Unnecessary

We found no evidence of harm to consumers that would warrant the regulation of destination clubs, despite some early experiences with this vacation segment. The two primary concerns for consumers are: (1) that they may not be able collect their membership deposit refunds should they choose to resign from the club, and (2) that they may not have access to the properties or the level of use they have been led to expect. The first issue of membership deposit refunds is of significant concern because of the large sums involved and the bankruptcy of Tanner & Haley, the originator of the destination club concept.

Refund of deposits

Those who wish to join a destination club must pay a membership deposit that ranges from $35,000 to as much as $3 million. The average deposit is about $450,000. Some new clubs are now waiving the initial membership deposit as an introductory feature.

Generally, the deposits may not be sold or transferred on the open market. The club, however, will give members a refund should they choose to resign. Depending on club policy, refunds may range from 80 percent to 100 percent of the deposit. Generally, members have no

guarantee that clubs have sufficient resources to refund all outstanding membership deposits. In addition, most clubs have a three in, one out policy, which means that a member who chooses to resign must wait until three new members join before receiving a refund. The case of Tanner & Haley is an example of the insecure nature of membership deposits.

The Tanner & Haley bankruptcy

The destination club industry is only about eight years old. Like any other new industry, it has suffered from growing pains. The bankruptcy of Tanner & Haley in 2006 is the prime example of what can happen to consumers. The 874 members of Tanner & Haley had paid membership deposits ranging from $85,000 to $1.3 million.[1] Instead of purchasing property with the deposits, Tanner & Haley used the funds for expensive leases and operating expenses. Apparently, Tanner & Haley owned only 67 properties in its inventory of approximately 200 homes that it advertised.[2] Since it leased most of these properties, Tanner & Haley faced operating costs that were much higher than its annual revenues. It reported a $64 million loss in 2005 due primarily to costly leases and under-priced membership deposits. Its business model was not workable.

Since members were unsecured creditors, they had no assurance of receiving any refunds on their membership deposits. However, when Ultimate Resort acquired the assets of Tanner & Haley, members were given the opportunity to join the new club, pay the annual dues, and continue to use the accommodations and services. They were promised a membership deposit refund after five years should they choose to resign at that time.

Corrections made

Most clubs have learned from the failed business model used by Tanner & Haley. According to the lead analyst at the Helium Report, none of the leading clubs are currently experiencing unusually high numbers of resignations or having any problems returning deposits.[3]

To remain competitive and viable, destination clubs recognize that they have to reassure potential customers of their financial stability. They have made a substantial effort at self-regulation to ensure responsible operations and the long-term success of the industry. The clubs now provide greater financial transparency and have created new business models that address the problems of the security of deposits and access to homes.

Efforts at self regulation

In 2006, seven destination clubs joined to create the Destination Club Association (DCA) to ensure fair and ethical practices. In July 2006, the association adopted a statement on *"DCA Industry Best Practices*" that focuses on four areas:

1. Comprehensive consumer disclosures including information on all club operations and thorough explanation of the club's resignation, termination, and membership deposit refund policies.

2. Accurate, truthful, and appropriate marketing and sales practices that comply with all applicable laws and do not involve deceptive or coercive acts.

3. Financial responsibility that ensures a club has the ability to meet its financial obligations and adequate financial resources for membership deposit refunds.

4. Commitment to responsible industry growth through education, building relationships in resort communities structured to permit destination clubs, and providing consumer protection through the development of appropriate industry regulation.[4]

The DCA has also adopted a "Code of Responsible Business Conduct" with which clubs must comply to become members. The code requires compliance with the DCA's *Industry Best Practices,* which includes: providing members who join with rescission rights within seven days of signing a contract; disclosures that describe club rules, accommodations, payments, termination rights and refunds; and evidence of financial responsibility, including an annual independent audit and a net asset test that assures the club has assets in excess of 66.6 percent of the aggregate amount payable to members upon termination. The code also lists a number of prohibited acts such as misrepresentation and overselling of accommodations.

Financial transparency

Destination clubs now offer members more transparent financial reporting. Many provide their members with an annual audited financial statement and quarterly reports. For example, Quintess assures its members of the security of their deposits by hiring a Big Four CPA firm to perform an annual audit and sending members a quarterly letter on the security of their deposits. In its most recent letter, Quintess reported that it is in excess of 100 percent on its contractual membership deposit liability coverage. The club is also working on developing a trust

structure where membership deposits become a "silent second mortgage" to ensure members do not become unsecured creditors in a worst-case scenario.[5]

Exclusive Resorts says that its policies and procedures confirm its financial strength. The club has an annual audit by a Big Four accounting firm. It says that it uses membership deposits only to purchase real estate. It also reports annually to its members on a "Net Asset Test" that demonstrates whether it has sufficient assets to meet all its debt obligations, including repaying all of the refundable membership deposits. The club says its resignation ratio is less than 4 percent a year and members wait less than 30 days for their refunds.

The club's membership agreement also provides for a "wind-down analysis" to determine its ongoing viability. In the event that it is experiencing financial difficulty, all club members who are due a refund would receive a notice of the overall value of club assets and would be allowed to vote on whether to liquidate the assets and terminate operations. Should members vote to terminate, the assets would be liquidated and distributed with the proceeds going first to any mortgage or other secured debt holder, and second to eligible members on a pro-rata basis.

Recently, High Country Club notified its members that it had completed its annual net asset test and had received an unqualified opinion on its 2006 financial statements from its independent accountants. Its net asset test showed that the club's assets exceeded its membership deposit obligations.

Innovative business models

Recent new business models, such as equity clubs, provide greater assurance of their refund obligations through asset protection measures. BelleHavens is a nonprofit destination club that is wholly owned by its members. The members own club properties without debt. BelleHavens' business model uses a private partnership company, Banyan Properties, to build or buy homes for the club, add them to the asset pool and then transfer them debt free to BelleHavens. The club keeps the initial deposit in escrow until five new members join. At that time, it purchases a home outright. The membership club then holds title to the property.

The LUSSO Collection assures its members of its long-term financial stability through a deposit trust program.[6] The membership deposit is 100 percent refundable. The membership contract contains a commitment that 85 percent of members' deposit will be used for acquiring properties or held in cash. All of the club's properties are held

by a subsidiary limited liability corporation that is fully owned by the club. It also provides members with audited financial statements and semi-annual reports on the extent to which its net assets cover the membership deposit fund. Members are also granted a security interest in the club's real estate assets in a trust so that they are next in line after secured debt.[7]

Crescendo is another variant of a destination club that operates like a real estate investment trust. It is regulated by the federal Securities Exchange Commission under federal securities laws. The club uses members' funds to buy homes, and members have the opportunity to capitalize on any appreciation that might occur. Quintess allows members to invest additional money to obtain equity in the club.

Improved reservation systems

Clubs have also improved the availability of accommodations by making adjustments to their membership and reservations systems and by buying more homes at key resort locations. For example, among its acquisitions, Exclusive Resorts has added, or plans to add, 28 residences at Kapalua Bay, Maui; 12 at Wailea; and 16 at Grand Cayman Island. Clubs have also created different tiers of membership that give those at the higher levels greater access during peak holiday periods. Reservations systems may designate a certain percentage of nights for advance reservations and the balance for short-term availability. They may rotate weeks among members so that most will have access during times of heavy demand, such as winter and summer holidays.

Before joining a club, advisors suggest that prospective customers look at the ratio of members to homes. The fewer members per home, the more likely it is that members can reserve the homes at their desired times and locations. The industry standard is one home for every six members, a 6:1 ratio. This ranges from 4:1 to as high as 10:1. Current ratios range from five to ten members for each home that is available. In addition to the member-to-home ratio, prospective members should consider the occupancy rate for the homes and the number of days of travel in the members' plans.

Prospective members are a small, select, sophisticated group

About eight destination clubs currently have properties in Hawai'i. The total number of club members worldwide is about 5,000. It is estimated that only about 15 are Hawai'i residents. Those who join destination clubs are a small, affluent group with incomes of several million dollars a year. They are generally knowledgeable, sophisticated consumers who have many resources available to help them make decisions about whether to join and which clubs would offer the best fit for their particular needs.

Consumers of vacation accommodations have many options. Those who join non-equity destination clubs *choose* to do so. Many of them already have a second home. Others choose to join to avoid the responsibility and costs of maintaining a second home. Although the membership deposit is substantial, most, if not all, of it is refundable. The annual dues may be less than the property taxes, maintenance, and other costs of a second home. Analysis shows that the total cost per day is less than comparable vacation homes, luxury hotels, or rental villas.

Consumers appear not to have been affected by the Tanner & Haley bankruptcy. Membership growth has been strong. Prospective members say that they are doing more careful due diligence before proceeding.

Financial advisors say that the smartest way to approach any prepaid leisure program is to think of them as products to be used and consumed. Membership in destination clubs is a lifestyle choice and not an investment choice. They should not be viewed as investments or products that should appreciate.

In addition to relying on financial advisors and attorneys, prospective members can find detailed information and reviews about each destination on the internet through the Helium and Sherpa reports. The reports provide decision guides and suggest the top due diligence questions that prospective members should ask. For example, “Can the club demonstrate that it has enough assets to meet its membership deposit refund obligations?” “What system does the club use for holiday and peak period reservations?” “What services are included in the fees?” “How many members have resigned and how long has each had to wait before receiving the deposit refunds?”

Consumers who prefer to use vacation products as investments also have a choice. They can join equity destination clubs. They can also purchase fractionals or other comparable high-end, time share accommodations in resorts operated by Ritz Carlton, Four Seasons, Marriott and others.

Several destination clubs say that joining a club is less risky than buying a second home. Robert Parsons, the CFO of Exclusive Resorts has said that the club is not so affected by the ups and downs of the stock market or the real estate industry since it can buy in bulk and purchase real estate early in sought after locations. In addition, the portfolio of homes is diversified worldwide and not concentrated in any one market. Ultimate Resort points out that its members do not incur the risk associated with real estate investments in an uncertain economy.[8]

Proposed Model Act Adds Little Protection

The proposed model act, Senate Bill No. 697, provides little added protection to consumers. Destination clubs already offer the two major consumer protection provisions in the bill: the seven-day rescission rights for buyers and disclosure requirements. In addition, the definition of a destination club in the bill limits its coverage to non-equity clubs.

Rescission rights

The bill allows a member to cancel a membership agreement before midnight of the seventh calendar day after the member signs the membership agreement or the date the member receives the disclosure statement. The deposit is held in an escrow account during the seven-day period. This protection appears to be unnecessary and unwarranted. We found no complaints about aggressive and deceptive sales practices that would pressure customers into buying and no complaints about "buyer's remorse." Destination clubs do not sell memberships through hotel booths that offer gifts and other inducements to entice customers to high pressure sales presentations.

According to Exclusive Resorts, consumers consider their membership purchases over a period of several months, not days. The club does no direct, person to person selling. Memberships are sold through a combination of referrals, direct mailings, and partnerships with companies like American Express and Neiman Marcus.

Disclosure and certification requirements

The bill's disclosure requirements are aimed at informing consumers of their rights and the club's responsibilities. It does little to guarantee the club's financial stability or the security of membership deposits. Senate Bill No. 697 requires destination clubs to provide prospective members with a written disclosure statement that includes a description of membership rights, the types and numbers of accommodations and services available, procedures and rules for use of accommodations, description of all payments due, the members' termination rights, and the process for obtaining a refund of the membership deposit, the number of members waiting to receive a refund and the current waiting time, the effect of bankruptcy on members' deposits, and certification that the club has sufficient resources to meet its obligations for two-thirds of the member deposits received and not refunded.

Each club must register biennially with the director of the Department of Commerce and Consumer Affairs. The registration must include a certification that it has the financial resources to meet its refund obligations. This is done either through a net asset test certified by the club operator or through third party commitments. The net asset test consists of the fair value of the club's assets less debts and 66.66 percent

of membership deposits. The test would do little to guarantee member deposits. In a non-equity club, members would probably be unsecured creditors who would be the last in line to get their money back.

Destination clubs would probably not opt for the alternative provision for a third party to commit to paying membership deposit obligations. The third party commitments would be expensive and difficult to get. According to one destination club, no insurer is willing to guarantee or put up a bond for hundreds of millions of dollars, particularly when the industry is so young and has no history of the risks involved.

Because of the number and variety of competitive options for vacationers, most clubs are already implementing measures to assure prospective members of the security of their membership deposits. They provide audited financial statements by independent CPA firms, create deposit trusts, or offer equity in the club's real estate assets.

Limited coverage of bill

The business models for destination clubs are still evolving. The definition of destination clubs in the bill covers only non-equity clubs. The bill defines a destination club as one where:

- Members pay a deposit, annual dues or other fees,
- Members may terminate the membership at any time,
- Members have the rights to temporary use of accommodations and other club services,
- Members receive no ownership interest in either the club or the club's assets, and
- Membership deposit will be refunded upon termination of the membership under the terms of the membership agreement.

This definition leaves out destination clubs such as BelleHavens that offer members equity interest in the club's assets. It may be premature to attempt to regulate a rapidly changing industry.

Time Share Law Is Inappropriate Regulation for Destination Clubs

The position of the Department of Commerce and Consumer Affairs has been that destination clubs are covered by and subject to Chapter 514E, HRS, as time share plans. However, it recognizes that destination clubs are different and that many of the provisions under Chapter 514E are not appropriate for regulating destination clubs.

The time share law was enacted to prevent rampant abuses early in the industry's history. Since these abuses are not characteristic of the operations of destination clubs, the consumer protection measures in the time share law are not appropriate for destination clubs. In addition, state and federal courts have declared that Exclusive Resorts' plans to use its destination club properties are not time share plans as defined under Chapter 514E, HRS. Finally, no other states regulate destination clubs under their time share laws.

Abuses unlike those in time share plans

The time share industry became heavily regulated during its rapid growth in the 1980s. Overly aggressive marketing practices, high-pressure sales presentations, bad management, and outright fraud were common complaints. Hotel booths manned by unscrupulous salespersons enticed passersby to attend high-pressure sales presentations where buyers often signed contracts before they knew what they were doing. Unscrupulous developers oversold units, failed to provide clear title to the units, and went bankrupt. In addition, plans were often poorly managed, resulting in high and unexpected maintenance costs for owners.[9]

Chapter 514E, HRS, sought specifically to protect consumers from these abuses. To prevent deceptive and fraudulent sales practices, the law requires all developers, acquisition agents, plan managers, and exchange agents to be registered. Sales and acquisition agents must be licensed real estate sales persons or brokers. The law prohibits the use of any promotional device including entertainment, prizes, or gifts without disclosing that they are for the purpose of soliciting sales in time share units. The law also prohibits deceptive trade practices and provides for a seven-day rescission period to void a contract to purchase.

To ensure the integrity of the developer, the law requires all funds to be held in escrow until the sale is closed and the time share interest is conveyed to the purchaser free and clear of any blanket liens. The time share instrument must also contain provisions assuring satisfaction of the one-to-one-right to use-night requirement, that is, that the developer is not selling more than the sum of the nights that owners are entitled to use in a given year.

To ensure proper management of time sharing plans, the law requires a plan manager to be registered and bonded. The plan manager must provide to a time share owners' association a budget that contains the estimated revenues and operating expenses for the association and the amount needed for the coming year. In addition, an audit by an independent public accountant is to be performed each year.

These regulations are neither necessary nor appropriate for destination clubs. Destination clubs are not characterized by abusive sales practices.

Membership contracts are not generally real estate transactions that are required to be free and clear of all liens. Members expect certain levels of service, but management fees or the costs of operating and maintaining the accommodations are not their concern.

Problematic implementation under time share law

The department's time share administrator acknowledges that destination clubs are different from time sharing plans. Many of the major provisions in the time share law would have to be waived, if compliance is not required, or modified to accept alternative arrangements allowed by law, on a case-by-case basis. Such inconsistent and inappropriate implementation of the law would weaken the regulation of time shares and result in an unsound regulatory program for destination clubs.

For example, the law's requirement that there be ownership associations to protect the rights of time share owners would not apply. The provisions for plan managers to present a budget to homeowners would not apply. It would also be difficult to require all membership sales to be made by licensed Hawai‘i real estate brokers. Most destination clubs do not sell directly, via person-to-person sales. It would be difficult to establish where and when sales are actually made. There is also the question about jurisdiction of sales made over the internet. The requirement for all monies to be held in escrow until the buyer receives the deed free from all liens would also be inapplicable since members in non-equity clubs have no ownership rights. The one-to-one use night that prohibits developers from selling more nights than are available during the year would also be inapplicable.

Courts say destination club use is not time share under Chapter 514E, HRS

In October 2004, several owners of property at Pauoa Beach Subdivision on Hawai‘i Island filed complaints in both state and federal court to prohibit and enjoin Exclusive Resorts from engaging in time share activities in the subdivision. The owners complained that Exclusive Reports' use of its property in the subdivision constituted a time share or time share use plan under Chapter 514E, HRS, specifically prohibited by the Pauoa Beach Subdivision residential covenants.

The Hawai‘i Third Circuit Court declared that Hawai‘i's time share law did not apply to Exclusive Resorts' plan to use its properties because club members do not have any ownership interest in the properties. The court also found that it was not a "time share use plan" since members would not have a fixed or vested right to use the residential units for a specific or discernable time on a periodic basis. Instead, members could make reservations to occupy a unit depending on its availability. Moreover, members could use a unit for more than the 60 days limit specified in the time share law.

The U.S. District Court judge also agreed that based on the state court's interpretation of Chapter 514E, HRS, Hawai'i's time share laws did not apply to Exclusive Resorts' plan to use its property.

Destination clubs not regulated under other states' time share laws

No other states currently regulate destination clubs under their time share laws. Most clubs are located in resort areas in states such as Colorado, Florida, California, South Carolina, and Hawai'i. Each of these states has a different time share law. Even though most of the time share administrators in these states view destination clubs as time share operations, none are regulated under the time share laws.

Colorado exempts destination club operations from its time share law because members may terminate at any time without penalty. Florida exempts destination clubs because the plans are for less than three years. California also exempts destination clubs if they have four or fewer units in a subdivision; in which case, they would be regulated under California's subdivision law. South Carolina has issued a no action letter stating that it has determined not to take action against Exclusive Resorts to enforce the provisions of the South Carolina Timesharing Plans Act.[10]

Current status of regulation in Hawai'i

In November 2006, Exclusive Resorts signed an Agreement of Voluntary Compliance with the Department of Commerce and Consumer Affairs. Under the agreement, the State would not take action against Exclusive Resorts and would place its investigation of the club on inactive status. In turn, Exclusive Resorts provided the department with information on the club including the names of officers, membership agreements, copies of advertising materials, financial information, and certification that it has sufficient assets to meet its obligations to members. The agreement lapsed as of May 2007.

During the interim, the department convened a working group to consider developing new regulations applicable to destination clubs. Senate Bill No. 697 is the model act developed, proposed, and submitted to the 2007 Legislature by the working group. The department is awaiting the outcome of pending legislation. The department plans to keep its options open should the bill not be enacted. The department director would decide whether to pursue the investigation of Exclusive Resorts and regulate destination clubs under Chapter 514E, HRS.

Conclusion

We believe that Senate Bill No. 697 should not be enacted because it does not meet sunrise criteria requiring evidence of abuse. The bill is an unnecessary regulatory measure that would add little consumer protection. Its major benefits would be to lend greater legitimacy and

credibility to the industry. It also appears to be a compromise measure by destination clubs subject to inapplicable regulation under Hawai‘i’s time share laws.

We also conclude that destination clubs should not be regulated under the State’s *Time Sharing Plans* law since the provisions in the law are inappropriate for regulating their operations. The State should issue a no action letter to Exclusive Resorts and close its investigation, which has been held in abeyance pending the enactment of Senate Bill No. 697.

Recommendations

We recommend that:

1. The Legislature not enact S.B. No. 697, 2007 Regular Session.

2. The Department of Commerce and Consumer Affairs close its investigation of Exclusive Resorts and issue a no action letter regarding its regulation under the Chapter 514E, HRS, the *Time Sharing Plans* law.

Notes

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1. Eileen Zimmerman, "If One Vacation Home Won't Do, How About a Bunch," New York Times, July 1, 2007.

2. Larry Olmstead, "Homes Away From Home," Cigar Aficionado, February, 2007.

3. Helium Report, "Decision Guide to Destination Clubs," April 2007 and Destination Club Association, July 2007.

4. Chris Taylor, "A Slice of Paradise; instead of owning a second home outright, more people are sharing the cost to get all the benefits," Money, November 2005.

5. Jamie Cheng, "Cost-per night analysis," www.heliumreport.com/destination-clubs, May 3, 2006.

6. Sherpa Report, "Destination Clubs: A Guide for Prospective Members," SherpaReportguide@sherpareport.com, June 2007.

7. Ibid., p. 10.

8. "Destination Clubs Explained," www.heliumreport.com/archives, July 2007.

9. Exclusive Resorts, http://www.exclusiveresorts.com.

10. Eilene Zimmerman, "If One Vacation Home Won't Do, How about a Bunch?" New York Times, July 1, 2007, www.nytimes.com.

11. Nick Copley, "An Introduction to One Key with Founder and CEO Jay Sapovits," www.Sherpareport.com, July 24, 2007.

12. Jamie Cheng, "Ultimate Resort Acquires Tanner and Haley Assets in $98 Million Deal," www.heliumreport.com/archives, November 21, 2006.

13. Avery Johnson, "Destination Clubs Seek to Reassure Investors," Wall Street Journal, online.wsj.com, September 26, 2006.

14. Helium Report op. cit, p. 1.

15. Jamie Cheng, “Ultimate Resort Acquires Tanner and Haley Assets in $98 Million Deal,” Helium Report, November 21, 2006.

16. Darren Everson, “Destination Clubs Try to Shore Up Their Image,” Wall Street Journal, online.wsj.com, September 13, 2007.

17. Kim Fredericks, “Self Regulation, the Destination Club Industry Takes Charge by Forming Its Own Club,” Vacation Homes, April/ May 2007, p. 74.

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1. Avery Johnson, op. cit.

2. Jamie Cheng, “Ultimate Resort Acquires Tanner and Haley Assets in $98 Million Deal,” op. cit.

3. Eilene Zimmerman, “If One Vacation Home Won’t Do, How About a Bunch?” op. cit.

4. Destination Club Association, “DCA Industry Best Practices,” Rev., July 26, 2006 in DCA Code of Responsible Business Conduct, October 1, 2007.

5. Jamie Cheng, “Quintess Partners with Leading Hotels of the World and Acquires More Homes and Members,” Helium Report, www.heliumreport.com, December 6, 2006.

6. Erin Harrison, “Risk & Reward, Financial Transparency of Luxury Destination Clubs Help Industry Thrive,” Executive Decision, June 2007, p. 70.

7. “LUSSO – More on financial security and disclosure,” Helium Report, www.heliumreport.com.

8. Erin Harrison, op. cit, p. 72.

9. The Auditor, “Sunrise Evaluation Report: Time Sharing,” Report No. 92-19, November 1992, p. 8.

10. Letter from Kenneth Kitts, Timeshare Program Coordinator, South Carolina Real Estate Commission to James Scavo, Attorney at Law, August 17, 2004.

Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the Department of Commerce and Consumer Affairs on December 7, 2007. A copy of the transmittal letter to the department is included as Attachment 1. The response of the department is included as Attachment 2.

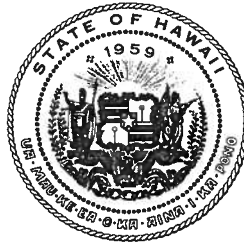
The department commented on the two recommendations in our report. It agreed that the proposed Senate Bill No. 697 is not acceptable in its current version and that the bill does little to guarantee the financial stability of destination clubs or the security of refundable membership deposits. Nevertheless, the department believes that some type of regulation is needed to protect consumers' membership deposits and rescission rights and to provide adequate disclosures.

The department believes that Chapter 514E, HRS, may apply to destination clubs but it prefers the establishment of a new chapter to regulate the industry. Our reasons why it is inappropriate to apply the time share law and unnecessary to regulate destination clubs remain unchanged. There is no evidence of abuse similar to the abuses found in the time share industry. The model act adds little protection as destination clubs are self-regulating and offer the two major protections: seven-day rescission rights for buyers and disclosure requirements. The department would have to apply the time share law in a piecemeal fashion and on a case-by-case basis. No other states currently regulate destination clubs under their time share laws.

The department provided no new evidence of harm to Hawai'i consumers to support its belief that consumers of destination clubs need protection. As noted in our report, the policies in the Hawai'i Regulatory Licensing Reform Act state that regulation should be enacted only when reasonably necessary to protect consumers. Neither Senate Bill No. 697, nor an inconsistent application of the *Time Sharing Plan* law, would offer any significant benefit to Hawai'i consumers.

ATTACHMENT 1

STATE OF HAWAI'I
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawai'i 96813-2917



MARION M. HIGA
State Auditor

(808) 587-0800
FAX: (808) 587-0830

December 10, 2007

COPY

The Honorable Lawrence M. Reifurth, Director
Department of Commerce and Consumer Protection
King Kalakaua Building
335 Merchant Street
Honolulu, Hawai'i 96813

Dear Mr. Reifurth:

Enclosed for your information are three copies, numbered 6 to 8, of our confidential draft report, *Sunrise Analysis: Destination Clubs*. We ask that you telephone us by Wednesday, December 12, 2007, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Thursday, December 20, 2007.

The Governor and presiding officers of the two houses of the Legislature have also been provided copies of this confidential draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

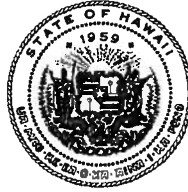
Marion M. Higa
State Auditor

Enclosures

ATTACHMENT 2

LINDA LINGLE
GOVERNOR

JAMES R. AIONA, JR.
LIEUTENANT GOVERNOR



LAWRENCE M. REIFURTH
DIRECTOR

NOE NOE TOM
LICENSING ADMINISTRATOR

STATE OF HAWAII
PROFESSIONAL AND VOCATIONAL LICENSING DIVISION
DEPARTMENT OF COMMERCE AND CONSUMER AFFAIRS
P.O. BOX 3469
HONOLULU, HAWAII 96801
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January 2, 2008

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OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion M. Higa
State Auditor
Office of the Auditor
465 S. King Street, Room 500
Honolulu, HI 96813-2917

Dear Ms. Higa:

The Department of Commerce and Consumer Affairs ("Department") appreciates the opportunity to comment on your report entitled Sunrise Analysis: Destination Clubs ("Report"). We offer the following in response to the Conclusion and Recommendations contained at the end of the Report.

The Auditor contends that the Legislature should not enact S.B. No. 697 (2007).

S.B. 697 was submitted by the destination club ("DC") industry with the concurrence of the Department, not because the regulation proposed in the bill had been agreed to (the Department, in fact, believed that the details of the bill required further discussion, and that it was not acceptable in its current version), but because both the industry and the Department believe that ***some*** regulation of DC is necessary, and that it would be preferable if that regulation was ***something other than*** the current chapter 514E, the State's time share law.

Although the Department believes that S.B. 697 is imperfect, we believe that DC regulation is necessary for reasons that are similar to those that support time share industry regulation. Without any type of industry regulation, protection of destination club consumers (e.g., mandatory financial assurances to protect purchasers' refundable membership deposits, disclosures that would allow purchasers to make informed decisions, and rescission rights) will be left solely to the good will of the industry. This is insufficient.

The Report states that the bill's disclosure requirements are aimed at informing consumers of their rights and the clubs' responsibilities, but do little to guarantee a club's financial stability. This criticism appears to miss the point. Disclosure requirements are not meant to guarantee a club's financial stability. Disclosure requirements are meant and are necessary to help consumers make informed decisions regarding purchase of a DC membership.

While the Department agrees that S.B. 697 currently does little to guarantee a DC's financial stability or the security of refundable membership deposits, we have been consistent in advocating for safeguards to ensure that the clubs will have sufficient money available to provide refunds. Rather than not regulate because of that, we recommend that we regulate better. Because the industry highlights the refundable membership deposit while marketing its product, consumers are led to believe that a refund will be given. Purchasers, on average, deposit $450,000 with the understanding that 80-100% will be refunded upon termination. Thus, DC consumers are at serious financial risk.

The Report also states that DC purchasers already have several months over which to consider their membership purchase and have many resources to help them make their decision, making rescission rights unnecessary. Although DC sales are not ordinarily high pressure, a rescission right is still an important protection, especially given the financial commitment of members. DC membership purchasers may be affluent, knowledgeable and sophisticated, but they are still consumers who should be afforded basic protections, and rescission rights are among the most important.

The Auditor contends that the Department should close its investigation of Exclusive Resorts and issue a no action letter regarding its regulation under Chapter 514E HRS, the *Time Share Plan* law.

The Auditor goes further than merely concluding that DC regulation is unnecessary, but recommends that the Department should not pursue enforcement of chapter 514E against DCs. While the Department respects the Auditor's review process, it is not clear if the Auditor has had access to regulatory or legal advice in reaching the conclusions that support that recommendation.

The Auditor's recommendation appears premised on the Third Circuit Court's ruling that the time share law does not apply to DC. The Third Circuit Court, however, is a court of limited jurisdiction and its decision does not affect other courts or represent state law. The Department respectfully disagrees with the court's ruling for a number of reasons, including:

- Chapter 514E does not require that purchasers receive a "fixed or vested right" to use a unit;
- Chapter 514E does not define either "time share unit," "time share interest," or "time share use plan" to require that members must be promised a particular unit from a specific date to a specific date every year;
- The DC under consideration offered, and continues to offer, membership plans for less than 60 days; and

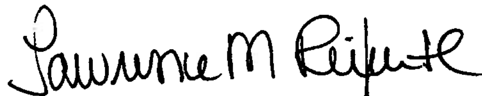
Summary

The Auditor notes that "most of the time share administrators in [other] states view destination clubs as time share operations" (see Report at page 29). Nevertheless, the Auditor observes that those same states do not regulate destination clubs under their time share laws. The Department respectfully suggests that while it does not know why time share administrators in other jurisdictions who view destination clubs as time share operators do not regulate them as such, since we believe that chapter 514E may apply to destination clubs, taking "no action" may be inappropriate under the circumstances.

Rather than regulate destination clubs under Chapter 514E, the Department prefers the establishment of a new chapter to regulate destination clubs as a separate industry to protect consumers' refundable membership deposits, to provide adequate disclosures, and to allow consumers to rescind their contracts within a reasonable time

Thank you for allowing our comments to be included in your Report.

Very truly yours,



Lawrence M. Reifurth
Director

LMR/LBVC:jan