

Urban Land

Capital Markets

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Condo-Hotels: Unregistered Securities?

Sale of a property with the intent to rent it out could qualify as sale of a security.

Nearly 1.7 million people in the United States own a vacation home or a second home, defined as a property that the owner occupies on a seasonal or periodic basis. Many people will purchase a second home expecting to rent it out when they are not using it and possibly to make a return on the purchase price. However, if the seller is appealing to a buyer's desire to make such a return, the sale of the real estate can turn into the sale of a security, the consequences of which can be significant for the seller.

This issue has garnered greater attention over the past several years as developers have reintroduced the concept of the "condominium-hotel."

A typical condominium-hotel project has the look and feel of a hotel, including a staffed front desk offering transient rental services, bellhops, a concierge, daily housekeeping, and often room service. The principal distinction from a typical hotel is that rather than a single hotelier owning the entire

complex, the individual hotel rooms are offered for sale to people who are permitted to rent their units as part of the hotel in return for a portion of the rental revenue.

The condominium-hotel structure offers a number of potential benefits for the developer. First, it provides a method to help finance the development of hotels: the sale of units gives the developer an assured source of revenue to repay a portion of the construction loan upon the completion of the hotel and the closing on the sale of the units. Additionally, a developer can benefit by marketing the hotel amenities to a purchaser.

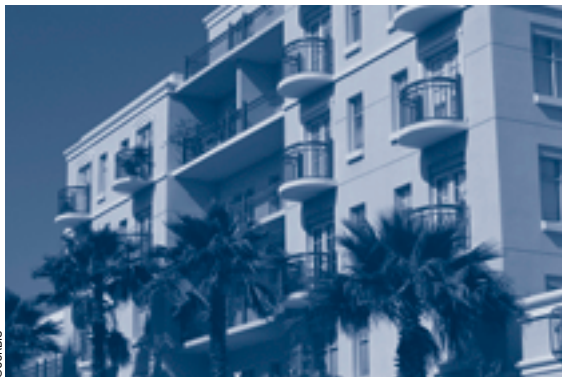
For years, the courts and the Securities and Exchange Commission (SEC) have struggled with how to determine whether the sale of real estate should be considered the sale of a security. In its

1973 release "Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sales of Condominiums or Units in a Real Estate Development," the SEC set forth its position on whether a condominium sale could be deemed a sale of a security in the form of an "investment contract." The commission indicated that, in general, a real estate developer may market condominium units for use as residences without the sale of the condominium units being deemed the sale of a security. However, this position does not provide much guidance to the developer of a condominium-hotel because use as a residence is only one possible reason for buying a condominium-hotel unit and is often not the primary goal.

To determine whether the sale of condominium-hotel units is considered the sale of a security, developers must first consider the definition of a security. In *Securities and Exchange Commission v. W.J. Howey Company*, 328 U.S. 293 (1946), the U.S. Supreme Court defined a security as an investment of money in a common enterprise with an expectation of profits produced by the efforts of others. The Securities Act of 1933, as amended, requires that the sale of a security be registered under the 1933 act, unless an exemption from registration is available. Although the SEC's position in the 1973 release still stands, the commission has taken the general position that when a developer directly or indirectly offers the condominium buyers collateral rental management arrangements, a security in the form of an investment contract may be present.

The 1973 release set up three categories of condominium offerings that the SEC would view as the offering of a security:

- the offering of participation in a rental pool arrangement whereby the rents received and the expenses attributable to rental of multiple units in the development are combined and the individual owner receives a ratable share of the rental proceeds, regardless of whether the individual unit was actually rented;
- the offering of a condominium unit together with a rental or similar arrangement in which the buyer must hold the unit available for rental for any part of the year, must use an exclusive rental agent, or is otherwise materially restricted in the occupancy or rental of the unit; and
- the offer or sale of a condominium with any rental arrangement



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or other similar service that emphasizes the economic benefits to the buyer to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, in rental of the units.

In each of these three categories, the SEC stated that the presence of rental arrangements indicates that the promoter of the condominium units is, in fact, offering potential buyers the opportunity to earn profits on their investment through the managerial efforts of the promoter or a third party, with the third party being the management company and the profits the buyers are led to expect consisting of revenues they will receive from the rental of their units. Therefore, if a developer decides to sell condominium units, to offer a rental program, and to emphasize the investment benefits of buying a unit, then sale of the condominium units would be classified as the sale of a security. Therefore, unless an exemption is available, the sale of the condominium units requires registration under the 1933 act.

A registration statement is a carefully prepared set of documents filed with the SEC before the public offering of a security. It must explain the offer, including the terms, issuer, planned use of the money, historical financial statements, and other required information that would help an individual decide the appropriateness of the investment. The SEC must declare a registration statement effective before it may be used in connection with a sale. Such a filing is frequently a time-consuming and expensive process; a search of the electronic filings with the SEC since 1996 produced only five such registration statements for condominium-hotels, and most of these were subsequently withdrawn.

The sale of an unregistered, nonexempt security gives the purchaser a right of rescission—the right to nullify a purchase contract without penalty. Accordingly, if a developer offers for sale condominium units that are considered a security without first registering the offering with the SEC or otherwise qualifying it for an exemption, the developer may unwittingly be giving all of the purchasers the opportunity to rescind the purchase agreements and get their deposits returned. Given these consequences, it is critical that developers familiarize themselves with the rules regarding when the sale of real estate can be deemed a security and implement procedures to adhere to the rules.

Faced with the alternatives of filing a registration statement or creating a right of rescission, developers have asked the SEC, through requests for no-action letters, whether it would view various marketing efforts as the offer of a security. A no-action letter is a response to an inquiry of the SEC staff in which the staff advises that it will recommend that the commission take no action—in other words, that no violation of securities laws would occur under the specific circumstances cited in the inquiry.

Notwithstanding the three categories set forth in the 1973 release, the SEC staff has stated that it will not recommend enforcement action if a developer offers and sells condominium units in accordance with the following requirements:

- no emphasis is placed on the economic benefits to the buyer to be derived from the managerial efforts of a third party or from renting the condominium-hotel units;
- no representations are made regarding the economic or tax benefits of ownership of the condominium-hotel units;
- there is no advertisement of the rental services;
- the availability of rental services is indicated to potential buyers only in response to direct questions from the buyer regarding rental activities;
- written material provided to prospective purchasers contains publicly available information concerning existing comparable facilities; the information must be in the form of raw data and may not contain rental projections, estimates, or assumptions involving speculation;
- no contract with any buyer for the provision of rental management services is entered into before that buyer contracts for the purchase of a condominium-hotel unit;
- the rental management services do not involve a pooling arrangement; and
- there are no limitations on owner occupancy of the condominium-hotel unit other than those established in generally applicable zoning regulations.

In the no-action letters, the SEC staff also has stated that a buyer is free to enter into a nonpooled rental arrangement with an agent after purchasing the condominium unit. The apparent source for this timing requirement is the case of *Hocking v. Dubois*, 885 F.2d 1449, 1459 (9th Cir 1989), which indicates that if condominiums and rental services are offered, sold, and/or bought as a package in the same transaction, then the purchase is likely to be deemed an investment in a security. Using the *Howey* definition of a security, the *Hocking* case implies that if a contract for rental services is signed after the purchase of the condominium unit is complete, then the “investment of money” requirement in the *Howey* definition is not satisfied. This result is not altered by the fact that some state laws provide for a rescission period for real estate purchase contracts. The SEC has suggested that a contract for the provision of rental management services cannot be binding upon the purchaser if the purchaser rescinds the condominium-hotel purchase contract for any reason before closing.

Alternatively, a developer could decide to sell condominium units and a rental program as a security. In that case, there would be no need to adhere to the above requirements, but such a sale would require registration under the 1933 act, unless an exemption is available. One exemption from registration is the private-placement exemption set forth in Regulation

D, promulgated under the Securities Act of 1933. This exemption requires that the securities—or condominium units and rental program—be sold only to accredited investors, or up to 35 persons who do not qualify as accredited investors (nonaccredited investors). An accredited investor is generally defined as an individual whose net worth or joint net worth with spouse exceeds \$1 million, whose individual income exceeds \$200,000 or joint income with spouse exceeds \$300,000 in each of the two most recent years, and who reasonably expects to reach the same income level in the current year. If the condominium units and rental program are sold as securities to nonaccredited investors, then the seller is obligated to provide all buyers with the information that the seller otherwise would be required to provide pursuant to a registration statement.

To comply with Regulation D, a seller is not permitted to offer or sell the condominium units by any form of general solicitation or general advertising. The SEC staff has taken the position that any advertisement of the condominium development, regardless of whether the advertisement mentions the hotel amenities or rental services, may be considered a general solicitation in violation of the private-placement exemption. However, this position has not been formalized in any written statement by the SEC.

Another exemption from registration is the Regulation S exemption: securities need not be registered under the 1933 act if they are offered and sold outside the United States using the procedures necessary to ensure that the offering is to offshore buyers not acting as conduits for distribution of the securities in the United States. Nothing in the research suggests that it would be impermissible for a purchaser to view a unit in the United States so long as the execution of any purchase documents and the closing take place outside the country.

The determination of whether the sale of condominium units and rental programs is equivalent to the sale of a security is further complicated by the fact that federal securities laws may differ from state law, and that state law varies from state to state. Some courts have adopted the approach that a vertical relationship must be present—essentially a one-to-one relationship between the investor and the promoter. The courts look at whether the fortunes of the buyer are interwoven with and dependent upon the efforts and success of those seeking the investment or of a third party. Other courts have adopted the horizontal approach—that is, whether a pooling of interests between the individual investor and the pool of other investors exists.

The condominium-hotel structure, while attractive, can prove problematic unless there is careful compliance with federal and state securities laws. Developers should consult with experienced counsel early in the planning process. ■