

Condominium Hotels and Securities Laws

Sponsors should be cognizant of federal requirements when structuring offerings.

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CONDOMINIUM hotels have gained increasing popularity during the past several years with the explosion of condominium construction in markets that attract purchasers seeking real estate investments and non-primary residences, and with the conversion of many established hotels to residential use. Much as some may be surprised to learn that the sale of interests in orange groves¹ or the receipt of profits from the racing of stallions² may involve the sale of securities for purposes of the federal securities laws, some sponsors and others in the business of selling condominium hotels³ may similarly be surprised to discover that the federal securities laws can apply in the condominium hotel context and can potentially result in civil liability under the federal securities laws.

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Sponsors should be cognizant of the federal securities laws when structuring condominium hotel offerings as such offerings may under certain circumstances involve the offer and sale of securities under the federal securities laws. As described below, however, even structuring an offering of condominium hotels to avoid the offer and sale of securities may dramatically impact the way that condominium hotels can be marketed and sold to prospective purchasers.

SEC Condominium Release

In order to address the uncertainty with respect to the applicability of the federal securities laws to condominium offerings, the Securities and Exchange Commission (the SEC) issued an interpretive release in 1973 addressing the issue of whether the offer and sale of condominiums and other units in a real estate development coupled with an offer or agreement to perform or arrange certain rental or other services for the purchaser of the condominium constituted a "security" for purposes of the federal securities laws.⁴

Offering and selling real estate in and of itself without any attendant arrangements to perform or arrange certain rental or other similar services does not implicate the federal securities laws. For example, the sale of condominiums, along with the services commonly provided for in a typical

residential condominium plan such as common area maintenance and valet service, do not trigger the federal securities laws. However, offerings of real estate coupled with an offer or agreement by the sponsor or other third party to perform or arrange certain rental or other similar services could involve an "investment contract" under the U.S. Supreme Court case *Securities and Exchange Commission v. W.J. Howey Co.* or a participation in a profit-sharing arrangement, thus constituting a "security" for purposes of the Securities Act of 1933 (the Securities Act).

In the event that such condominium hotel offerings constitute the offering of securities, the registration and prospectus delivery obligations of §5 of the Securities Act must be complied with. Moreover, such condominium hotel offerings would be subject to the liability provisions of the Securities Act and the Securities Exchange Act of 1934 (the Exchange Act), and persons who are in the business of buying or selling such condominium hotels may be deemed brokers or dealers under the Exchange Act and could thus be required to register under §15(b) of the Exchange Act.

While noting that there may be a variety of condominium arrangements that could constitute securities under the federal securities laws and that the analysis is a facts and circumstances determination, the Condominium Release provides that the

following three types of condominium hotel arrangements are deemed securities:

- Condominiums with any rental arrangement or other similar service that are offered and sold with emphasis on the economic benefits to the condominium purchaser to be derived from the managerial efforts of the promoter or a third party designated or arranged for by the promoter, from the rental of the condominium units;
- The offering of participation in a rental pool arrangement; and
- The offering of a rental or similar arrangement where the condominium purchaser must hold the condominium unit available for rent for any part of the year, must use an exclusive rental agent or is otherwise materially restricted in the occupancy or rental of the condominium unit.

In order to understand how condominium hotels may be deemed securities under the federal securities laws and thus subject to all of the attendant requirements, restrictions and liability provisions, one must first understand the concept of “investment contracts” under the *Howey* case, which provides that an investment contract is “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party...”⁵

In applying the *Howey* analysis to the offer and sale of condominium hotels, three out of the four elements of the *Howey* investment contract test are typically readily met: (1) the condominium purchaser invests a sum of money to purchase the condominium hotel, (2) there is a common enterprise, typically by virtue of the relationship between the condominium purchaser and the sponsor of the condominium offering,⁶ and (3) profits are generally derived from the efforts of the rental management service that is charged with renting and marketing the condominium units for rental.⁷

In the case of condominium hotels, the investment contract analysis typically focuses on the *Howey* prong relating to “expectation of profits.” The Condominium Release indicates that the “profits” that the purchaser is led to expect may be the revenues that are received from rental of the condominium unit, with the revenues and tax benefits resulting from rental of the unit constituting the “economic inducements held out to the purchaser.”

Accordingly, the focus of the expectation of profits prong is not on any potential appreciation that the purchaser may obtain from the condominium unit itself, but rather, from the potential rental revenue that the purchaser will receive based on the efforts of the rental management service. Important to the expectation of profits analysis is how the condominium hotel offering has been marketed and promoted to prospective purchasers, as well as the economic inducements provided to the prospective purchaser.

In the event that an offering of condominium hotels involves a security, the sponsor and others involved in the offering are subject to the requirements, restrictions and liability provisions of the federal securities laws.

The Condominium Release also indicates that condominium hotel offerings involving rental pool arrangements whereby condominium owners receive a ratable share of the rental proceeds regardless of whether their units were actually rented constitute investment contracts. Another instance where condominium hotels may constitute securities involves rental management agreements that impose material restrictions on condominium owners, such as requiring condominium owners to use an exclusive rental agent or imposing a limitation on the time period during which condominium owners may use the condominium. The SEC expressed the view that such arrangements suggested that the condominium owner was purchasing the condominium as an investment in a business enterprise with a return that was substantially dependent on the managerial efforts of third parties.

SEC Staff No-Action Positions

In addition to the Condominium Release, the SEC staff has issued a number of no-action letters since the 1970s that build on, or clarify, the interpretive guidance provided in the Condominium Release as to when condominium hotels may be deemed securities. Generally, consistent with the Condominium Release, the no-action letters provide that marketing activities as to the rental arrangements must

be limited. Condominium hotel offerings that use advertising, sales literature, promotional arrangements or oral representations that focus on the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter in renting the condominium hotels, will constitute securities. As a result, condominium sponsors should exercise care regarding the content of marketing brochures, the substance of verbal descriptions of the rental arrangements by salespersons, and any other aspect of the marketing and sales process in which information is provided to prospective purchasers.

In contrast, condominium hotel offerings that emphasize the recreational and vacation home aspects, rather than the economic benefits to be derived, are less likely to constitute investment contracts. Prior to 2002, condominium hotel salespersons and promotional materials could not mention the existence of a rental management service unless it was in response to a specific inquiry by the prospective purchaser.

In the most recent no-action letter relating to condominium hotels issued in November 2002 (which was signed on behalf of the SEC staff by co-author David C. Lee), the SEC staff permitted salespersons and marketing materials to make limited mention of the rental management service in the form of one sentence: “Ownership [of the condominium hotel] may include the opportunity to place [the condominium hotel] in a rental arrangement.”⁸ The ability to affirmatively mention the existence of rental management services reflects the SEC staff’s view that such a limited statement does not cause there to be an emphasis on the economic benefits of the rental management service. Projections as to future rental income or expected occupancy rates as to the condominium hotels may not, however, be provided to the prospective buyers on the basis that such information may place emphasis on the benefits that the condominium purchasers were to receive in the form of a return on their investment from rental income.

Representations and discussions by salespersons relating to the condominium unit itself and the sponsor, and not the rental management arrangements, should not raise federal securities law concerns. Such discussions may include the financial and managerial strength of the sponsor in terms of maintenance, resale value, or credit behind any obligation to perform warranties

on construction and stand behind warranties and the resale value of the condominium due to the strength of the brand and track record of the sponsor. Because these discussions do not focus on the potential profitability of the rental management aspects of the offering, but rather, relate to the condominium unit or the sponsor, the expectation of profits prong of the *Howey* test is likely not met and thus likely does not result in an investment contract.

Because the Condominium Release is a statement by the SEC itself (as opposed to interpretive guidance by the staff of the SEC), the SEC staff is restricted in its ability to deviate from the general guidance provided in the Condominium Release. Nevertheless, because the Condominium Release only provides general interpretive guidance, the SEC staff is afforded some flexibility in providing interpretations in areas that the Condominium Release does not specifically address. It is important to note, however, that SEC staff no-action positions are not binding and that the SEC staff may, at any time, change its positions or views. In this regard, the SEC staff has informally indicated that it may revisit certain of its prior no-action positions in the condominium hotel area and thus could change its existing views.

Consequences

In the event that an offering of condominium hotels involves a security, the sponsor and others involved in the offering are subject to the requirements, restrictions and liability provisions of the federal securities laws. Importantly, the condominium hotel offering will be subject to the registration and prospectus delivery requirements of §5 of the Securities Act, which requires that every offer and sale of a security be registered and mandates the delivery of a statutory prospectus. In the event that the condominium hotel offering is not registered, an exemption from registration must be available; otherwise, the offering violates §5.

Because most, if not all, condominium hotel offerings involve some form of advertising of the condominium hotels to the public, a number of possible exemptions from registration will not be available, as these exemptions require that there is no general solicitation.⁹ Practically, sponsors thus would not be able to advertise the condominium hotels, which is likely

neither feasible nor desirable in terms of the marketing and selling of the condominium hotels. Thus, condominium hotel offerings involving securities that are not registered would likely not fall within an exemption and would thus violate §5.

The consequences of a §5 violation are significant and include the ability of purchasers to rescind the condominium purchase under §12(a)(1) of the Securities Act, which provides for liability when a person offers or sells a security in violation of §5. Thus, purchasers receive a "put" right against the sponsor for a one-year period. Such a put right is especially troubling in the event of a decline in the real estate market where purchasers would presumably be more likely to exercise such rights. In addition, there may not be a source of funds to perform the put where the construction financing requires that the proceeds from the sale of the condominium units be applied to pay off the construction financing, at least until a specified percentage of unit sales (and corresponding paydown of the principal balance) has been achieved, and/or where unit sales proceeds are available only to the extent that the sales prices realized exceed the scheduled release price for each condominium unit.

Purchasers could also sue under the antifraud provisions of the Exchange Act, such as §10(b) and Rule 10b-5, for material misstatements or omissions in connection with the purchase of the condominium hotel, and receive monetary damages. There is the additional risk of an enforcement action by the SEC. While the SEC thus far has not brought an action in the condominium hotel area, it is possible that the SEC could bring such an action, particularly if there is an instance of non-compliance that would make for a "good" example case.

In addition to issues relating to registration, prospectus delivery and liability, persons who are in the business of buying or selling investment contracts or participation interests may be deemed brokers or dealers under the Exchange Act and thus could be required to register as a broker or dealer under §15(b) of the Exchange Act.¹⁰ Practically, registration as a broker or dealer and compliance with the broker-dealer regulations would be burdensome in the context of condominium hotels, and would exclude real estate brokers and salespersons not willing or able to complete the broker-dealer registration process. On the other

hand, sponsors of projects in which interests are offered only by registered broker-dealers could perhaps enjoy a competitive advantage due to the added security that prospective purchasers may obtain in the integrity of the information provided resulting from the highly regulated nature of registered broker-dealers.

Conclusion

Structuring condominium hotel offerings requires careful consideration of the federal securities laws. While some may view the requirements resulting from compliance with the Condominium Release and SEC staff no-action positions to be burdensome, such compliance would, for most, likely be preferable to the consequences of being deemed to have offered or sold securities for purposes of the federal securities laws. In the event that condominium hotel offerings violate §5 of the Securities Act, purchasers can "put" their condominium hotels back to the sponsor, effectively exposing sponsors to significant risk.



1. See *Securities and Exchange Commission v. W.J. Howey Co.*, 328 U.S. 293 (1946).

2. See, e.g., *Syndication of Star Reclut*, SEC No-Action Letter (Dec. 16, 1993).

3. For purposes of this article, a condominium hotel is a condominium that is offered with a rental management service that, for a fee, markets and rents the unit when not used by the condominium hotel purchaser, who receives rental income.

4. See SEC Release No. 33-5347 (Jan. 4, 1973) (the Condominium Release).

5. *Howey* at 299.

6. While beyond the scope of this article, courts have generally recognized two types of commonality: vertical and horizontal. The relationship between the condominium purchaser and the sponsor typically involves vertical commonality.

7. Courts have modified the requirement that profits be derived "solely" from the efforts of others as provided in *Howey* to one where the profit expectation depends to an essential degree on the efforts of others. See, e.g., *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973).

8. *Intrawest Corporation*, SEC No-Action Letter (Nov. 8, 2002).

9. For example, §4(2) of the Securities Act (the so-called private placement exemption) is an exemption that is available if, among other things, the securities are offered and sold to sophisticated persons and there is no general solicitation in connection with such offering.

10. See Division of Market Regulation's Broker-Dealer Compliance Guide available at <http://www.sec.gov/divisions/marketreg/bdguide.htm> (indicating that "there is no general exception from the broker-dealer registration requirements for licensed real estate brokers or agents who engage in the business of effecting transactions in real estate securities. In the past, the Division staff has granted no-action relief from the registration requirements to licensed real estate personnel that engage in limited activities with respect to the sale of condominium units coupled with an offer or agreement to perform or arrange certain rental or other services for the purchaser. The relief provided in these letters is limited solely to their facts...")