



Marketing and selling condo-hotel units without registering with the SEC

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Selling hotel rooms to private owners is not a new business idea, but recently more and more real estate developers have been embracing this concept. In South Florida alone, over 30 condo-hotel projects have opened or are being developed.

Typically, a condo-hotel is a luxury hotel development that sells all or a portion of its hotel rooms as condominium units to individuals. While unit owners earn rental income to offset ownership costs, potential appreciation seems to be their primary financial benefit.

For developers, pre-sold condo units can count toward equity, providing another source of capital for the development of the property, such as construction loans. In addition, according to National Real Estate Investor magazine, developers' returns for condo-hotel development projects of 25% to 30% are also significantly higher than those for conventional hotels.

Developers have to be careful, however, about how they market and sell condo-hotel units to the general public. When sold as an investment, the sale of such units may be viewed by the federal government and courts as a sale of a "security" within the meaning of the Securities Act of 1933. This has been an important issue for the Securities and Exchange Commission, as evidenced

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by the SEC's issuance of an interpretative release and numerous no-action letters on the offer

and sale of the units in real estate developments, as well as the SEC's enforcement actions against offenders.

While it is unlawful to sell securities to the general public without registration (unless an exemption is available), securities lawyers can help developers structure condo-hotel offerings in such a way so as to avoid any potential violations of the federal securities laws and to avoid the time consuming and costly registration with the SEC.

Defined by the U.S. Supreme Court in the famous *Howey* case, the presence of the following three elements would constitute a "security": (1) an investment of money, (2) a common enterprise and (3) an expectation of profits from the efforts of the promoter or a third party.

Over the years, the SEC has provided further analysis and guidelines for this issue. Specifically, the SEC explained that a unit offering in conjunction with any one of the following collateral arrangements requires registration of the offering with the SEC:

■ The offering or selling of units with an emphasis



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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.

■ The offering or participation in a rental pool arrangement.
■ The offering of a rental or similar arrangement whereby the purchaser must use an exclusive rental agent, hold his unit available for rental for any part of the year, or is otherwise materially restricted in his occupancy or rental of his unit.

Because every case is different and the application of the above guidelines is fact-specific, securities lawyers should review the SEC no-action requests related to the offerings of condo-hotels. A no-action letter typically describes in detail a specific project and specific marketing and sales procedures to effectuate the offering and sale of the units, while asking the SEC to confirm that the described offering will not require registration with the SEC.

It is evident from reviewing the no-action letters on this topic that many factors will play a significant role in deciding whether a condo-hotel unit offering is an offering of a "security." For example, the buyers of condo-hotel units cannot be materially restricted in occupancy or rental of their units. What constitutes a material restriction is highly factual. Many condo-hotels' use restrictions are related

to local zoning regulations. While this factor is not dispositive in the analysis whether a restriction is material, it has been widely used in no-action requests.

In one development, motel units had to be made available for rent for periods of less than one week, and the owners' association had the power to compel the owners to make their units available for rental. The SEC did not recommend enforcement action because, among other reasons, the restrictions on occupancy and an obligation to rent were imposed by pre-existing zoning regulations rather than by the developer.

Further, no mandatory rental, leaseback or similar arrangement in which the buyers of condo-hotel units are required to use an exclusive rental agent is permissible. The decision to enter into a developer's rental or leaseback program should be completely independent from the decision to purchase the unit from the developer. While it is permissible to locate a rental management office in proximity to the sales office, the sales personnel should not present the developer's rental or leaseback program to prospective purchasers as a way to derive an economic benefit from the ownership of the units and should not provide projected rental information or any information regarding potential occupancy rates.

The timing of the buyer's entering into the rental agreement and the purchase and sale agreement and the contingency of one upon the other are also very important factors. In one instance, the SEC took a no enforcement position with respect to the offering in which the rental agreement was not entered into prior to the execution of the purchase and sale agreement, and the effectiveness of the rental agreement was not conditioned upon the consummation of the sale.

There are many other factors that will make a difference in the analysis whether certain condo-hotel units may be characterized as securities. Careful review of the SEC materials will enable a particular condo-hotel unit sales program to be structured in a way to ensure compliance with the federal securities laws. Alternatively, if there are no useful precedents for a particular situation or one wants to be assured that the offer and sale of the condo-hotel units will not result in a violation of the securities laws, a developer may ask the SEC for a no-action ruling that will apply to such developer's specific facts and circumstances.

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