

TRENDS IN REAL ESTATE AND TITLE INSURANCE

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THE LATEST real estate trend in the hospitality industry, across the country and around the world, is the "condo hotel." The number of existing hotels being converted to condo hotels and new construction projects designated for condo hotels is increasing. In New York, the Plaza will soon re-open as a condo hotel, and other storied hotels, including the Mayflower, Helmsley Windsor, Intercontinental, and Empire, were recently subject to conversion. Estimates are that approximately 100,000 condo hotel units are in the pipeline. Hotel occupancy rates for the year are close to 90 percent, and average hotel room rates are up by more than 40 percent since Sept. 11, 2001.¹

The proliferation of condo hotels is due in large part to their attractiveness to developers, lenders, and purchasers. However, those involved with condo hotels need to familiarize themselves with the new and unresolved legal issues that may arise, particularly whether the sale of a condo

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*Do sales of units require registration
and compliance with federal securities laws?*

hotel unit constitutes the sale of a security requiring registration and compliance with federal securities laws.

The Condo Hotel: What Is It?

A condo hotel resembles, and is managed and operates as, a traditional hotel, except that in a condo hotel certain hotel rooms are offered for sale as condominium units to individual buyers. The condominium units generally resemble hotel guest rooms and typically include standard hotel decor and amenities. Condo hotels come in a variety of shapes and sizes. For example, some designate certain floors for condominiums, while others delegate those units to separate buildings sharing common areas with hotel guests. In addition, condominium owners usually have the option of placing their units in a reservation system or rental program and sharing in any associated fees.

Why the Buzz?

The proliferation of the condo hotel is largely the result of the benefits that condo hotels afford developers, lenders, and buyers. For a developer, the condo hotel provides the opportunity to turn a quick profit upon sale of condominiums as opposed to the incremental profits traditionally associated with the cyclical hotel industry. Indeed, it has been reported that a condo hotel unit can generate prices equivalent to 20 years' worth of revenue for a luxury hotel room.² Lenders are also more likely to support developers as a result of the potential return on investment realized with condominium sales (even

prior to construction).

Finally, the condo hotel provides increased selling power to buyers looking to own a residence with all the amenities associated with traditional hotel accommodations, including room service, valet, housekeeping, and other luxuries offered by the many upscale hotel brands that have entered the condo hotel market. Indeed, condominiums associated with hotels price at significant premiums above traditional condominiums.³

New Management Issues

Because the current condo hotel concept has only recently flourished, few reported legal issues have arisen. However, hotel management companies need to be aware that managing a hotel is not the same as managing a condo hotel, and they will need to quickly adapt to running overlapping hotel and condominium operations.

Among other things, hotel management companies need to be careful about fulfilling their obligations to unit owners, non-owner guests, and the hotel brand. For example, the noisy hotel guest in the room next door can become a significantly more complicated issue when that guest owns his unit. In addition, hotel management companies are likely inexperienced in dealing with condominium associations, which often wield considerable power and have been known to file lawsuits, including class actions, relating to everything from construction and marketing to sales and warranties.

In addition, after spending hefty sums to acquire a condo hotel unit, buyers are likely to be more demanding than the average transient hotel guest. Moreover, there are new requirements of which to be aware, including state-specific zoning and condominium laws and regulations. Hotel management companies should also carefully review their management agreements before converting some units to condominiums to ensure that they are not violating any obligations to owners of hotels in their market area.

Nevertheless, the most serious issue—already a topic of conversation in the hospitality industry—is whether the sale of a condominium unit constitutes the sale of a security under the federal securities laws.

Sale of a Security?

Generally, the offer for sale of real estate does not involve the offer of a security. However, as explained below, because a condo hotel unit is associated with a rental or management program, it can, in certain circumstances, be deemed a security. If so, unless the sale is exempted, the sale must be registered with the Securities and Exchange Commission and comply with the SEC's rules and regulations, including its anti-fraud provisions. Accordingly, developers or brokers could face serious criminal and civil liability repercussions. In addition, condo hotel sellers could be deemed securities brokers or dealers within the meaning of the Securities Exchange Act and may be required to be registered as such. Finally, if a condo sale is considered that of a security and that sale is not registered, the buyer could void the sales contract.

In *Securities and Exchange Commission v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946), the U.S. Supreme Court defined an "investment contract," which is considered a security, as "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." Since an investment contract is a security, the sale or purchase of a condo hotel unit will be classified as the sale and purchase of a security when, based on the "economic realities," that purchase is deemed to be: (i) an investment of money; (ii) in a common enterprise; with (iii) the expectation of profits solely from the efforts of the

promoter or a third party. *Id.*

In 1973, the SEC issued a release to address the "uncertainty about whether offers of condominiums and other types of similar units may be considered to be securities" (Condominium Release).⁴ Noting that while "[t]he *Howey* case involved the sale and operation of orange groves,[] [t]he reasoning, however, is applicable to condominiums." The SEC concluded that an offering of securities in the form of an investment contract will arise if:

1. the condominiums, with any rental arrangement or other similar service, are offered and sold with emphasis 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, from rental of the units;
2. the offering of participation in a rental pool arrangement; and
3. the offering of a rental or similar arrangement, whereby the purchaser must hold his unit available for rental for any part of the year, must use an exclusive rental agent or is otherwise materially restricted in his occupancy or rental of his unit.

It is significant for today's combined managers and property owners that the Condominium Release states that "an owner of a condominium unit may, after purchasing his unit, enter into a non-pooled rental arrangement with an agent not designated or required to be used as a condition to the purchase," but also warns that "there may be situations, not referred to in this release, in which the offering of the [condominium] interests constitutes an offering of securities."

In 2002, the SEC issued a "no action" to Intrawest Corporation concerning "the applicability of the federal securities laws to the offer and sale of condominium units, or 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" (Intrawest Letter).⁵

Intrawest, a condominium hotel developer in Canada, noted that over 80 percent of its condominium purchasers placed their unit(s) in some form of rental management structure and often requested information from Intrawest regarding rental possibilities prior to their purchases. Intrawest wanted to institute a sales and promotional program for its U.S. developments enabling it to disclose the existence of the rental management programs as one of the services offered, without SEC registration.

Based on the facts as presented by Intrawest, the SEC stated that Intrawest's sales and rental model did not create a security as defined by *Howey* and the Condominium Release because, among other things, the promotion and sale of units did not emphasize any economic benefit to the purchaser derived from managerial efforts or rentals and did not offer participation in a rental pool.

However, the Intrawest Letter was founded upon very specific facts, including Intrawest's representations that: (1) under no circumstances will a prospective purchaser be led to believe that he, she, or it will profit from the ownership of the units by any means other than the appreciation in value of the property; (2) Intrawest's real estate sales personnel were only permitted to mention that "Ownership may include the opportunity to place your home in a rental arrangement;" (3) representatives of the rental management company only provide information in response to specific inquiry; (4) Intrawest's rental management program will be completely voluntary and separate and distinct from the Intrawest sales program; (5) real estate sales representatives will not receive additional compensation or other incentives for unit sales to individuals who also enter into rental management agreements with Intrawest or an affiliate; and (6) Intrawest will not discuss the terms of, or agree to enter into, rental management agreements with individuals until a purchase and sale agreement has been executed.

Conclusion

As a result of the condo hotel explosion, new legal landscapes are likely to emerge. In addition, although developers and brokers would be wise to comply with the SEC's Condominium Release and Intrawest Letter, no court has yet pronounced on whether or not a condo hotel sale constitutes that of a security.

It is clear, however, that to avoid being deemed a security, at minimum, a condominium sale must not be tied to any pooling of rents and must be advertised, marketed, and sold as a piece of real estate, carefully avoiding associating that sale with any management or rental program. The manner of offering and the economic inducements held out to the prospective purchaser both will play an important role in determining whether the offering involves a security. In sum, it would be wise for those involved with condo hotels to hire counsel familiar with hotels, condominiums, and securities law.

1. See Michael Stoller, "Condominium Conversions Boost the Hotel Industry," *New York Sun*, Sept. 22, 2005.

2. See Alison Gregor, "Hotels Check In Condo Buyers," *The Real Deal*, *New York Real Estate*, Jan. 20, 2005.

3. See Sheila Muto, "Making a Hybrid Home Your Vacation Escape," *The Wall Street Journal Online*, May 21, 2003.

4. See SEC Release No. 33-5347, Jan. 4, 1973, 1973 SEC LEXIS 3277; 38 FR 1735.

5. See Intrawest Letter, at www.sec.gov/divisions/corpfin/cf-noaction/intraw110802.htm.