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Practice Update

# Condominium Hotel Units: On the Benefits of Being a Security

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The potential application of federal and state securities laws to the sale of condominiums when coupled with the opportunity to participate in a rental program (sometimes referred to as a "condohotel," "condominium hotel," or "whole ownership rental program") has long posed significant challenges for developers. For many years it has been common practice for developers to avoid selling securities at all costs. This article describes recent changes in federal securities laws that change the analysis of this issue significantly.

**The analysis prior to new federal Rule 506(c)**

Prior to the effectiveness of Rule 506(c) of Regulation D in September 2013, if an offering of condominium hotel units were to constitute a securities offering, the offering would generally have been required to be registered with the Securities and Exchange Commission (SEC) as a public offering. Although the offering could in theory have proceeded as a private placement to accredited investors (i.e., investors meeting minimum income, net worth, asset or other tests contained in Regulation D), the marketing of condominium hotel projects has been reliant on media advertising and exposure to the public through broker networks. Such broadly

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communicated marketing messages constitute "general solicitation and advertising" within the meaning of Regulation D and until recently were prohibited in connection with an offering under Rule 506 of Regulation D, the exemptive rule typically relied upon to conduct a private placement. Consequently, as a practical matter, hotel condominium offerings could not be conducted as exempt offerings within the United States. Because the alternative, conducting a public offering, involves a protracted and expensive registration process with the SEC, as well as the imposition of a variety of restrictive rules for communicating with investors, developers have had no choice but to ensure that condominium hotel offerings did not constitute securities.

At the same time, avoiding the application of securities laws requires a structure that is also fraught with challenges. SEC guidance published in 1973[1], which continues to outline the relevant considerations in determining whether a condominium hotel offering will be viewed as an offering of securities, indicates that a securities offering is likely when any of the following factors is present:

- The condominiums, with any rental or similar arrangement, are offered and sold with emphasis on the economic benefits to the purchaser to be derived from the efforts of the promoter (or a third party designated or arranged for by the promoter) in renting the units
- Revenues from various units are pooled
- The purchaser is required to hold the unit available for rental for any period of time or to use an exclusive rental agent or is otherwise restricted in its occupancy or rental of the unit

The most prevalent pitfalls of offering condominium hotel units in a manner that appropriately addresses these restrictions are:

- The lack of certainty as to the number of condominium units that will participate in a voluntary rental program and managing the leverage entailed in threats of defection from the rental program
- The prospect of outside rental programs creates numerous challenges including the accommodation of outside housekeeping staffs and onsite responsibility for guests of outside programs
- A lack of transparency with respect to the anticipated costs and benefits of participation in the rental program, which frequently results in purchaser dissatisfaction based on unrealistic expectations concerning economic performance
- The inability to pool the operating revenues and expenses of participating units creates a series of operational complexities, including those associated with ensuring fairness in connection with the rotation and complimentary use of rental units that have differing levels of appeal to transient occupants

**The effect of new Rule 506(c)**

After years of struggling with the negative repercussions of selling a condominium intended for transient occupancy that is not a security, revisions to Rule 506 adopted pursuant to the Jumpstart our Business Startups Act of 2012 (JOBS Act) have opened the door to the offering of condominium hotel units by permitting general solicitation and advertising in a Rule 506 private placement as long as any purchasers who invest in the offering are accredited investors. This revision makes it feasible to structure a condominium hotel product as a securities offering (i.e., by imposing a mandatory rental program or a pooling of revenues and expenses and/or by emphasizing the economic benefits of participation) and market the offering through traditional media and broker channels without being subject to a costly and time-consuming SEC securities registration process. The

accredited investor tests for individuals are currently set at levels[2] that are not likely to exclude a significant segment of purchasers who would otherwise fall within a developer's target market for a condominium hotel project[3].

Specifically, new Rule 506(c) permits an unregistered offering to be conducted using general solicitation and advertising provided the following requirements are met:

- The investment may only be sold to accredited investors. Although a traditional Rule 506 private placement permits the inclusion of up to 35 non-accredited investors in the offering (subject to the satisfaction of disclosure and investor sophistication requirements), all purchasers in a Rule 506(c) offering must be accredited investors (or reasonably believed to be so).
- Reasonable steps must be taken to verify accredited investor status.
- The SEC's "bad actor" prohibitions, adopted concurrently with the adoption of Rule 506(c), prevent any issuer (whether or not engaging in general solicitation) from relying on Rule 506 to conduct an offering exempt from registration if at the time securities are sold the issuer, any director, executive officer or other officer participating in the offering, promoter, placement agent, or 20% owner of outstanding voting equity has, after the effective date of Rule 506(c), been convicted of or enjoined from committing certain securities-related legal violations or becomes subject to professional debarment imposed by the SEC, the Commodities Futures Trading Commission or certain other regulatory agencies. It is incumbent upon issuers in Rule 506 private placements to conduct due diligence to ensure that the registration exemption has not been compromised by the participation of bad actors and to ensure that disclosure obligations are satisfied.

- There is a likelihood of future rulemaking concerning Rule 506(c) that would not substantially impact the advantages of Rule 506(c) to condominium hotel developers and other project sponsors.

As with other Rule 506 offerings, condominium units purchased in a Rule 506(c) offering would be exempt from most state regulation related to the offering and sale of the securities themselves(although state securities considerations would continue to apply to the sales personnel involved in marketing the units). State notice and filing fee requirements continue to apply to these offerings.[4]

Additionally, and consistent with other Regulation D offerings, conducting an offering pursuant to Rule 506(c) does not eliminate the application of a variety of provisions of the federal securities laws, including:

- **The anti-fraud provisions of Rule 10b-5** -The issues associated with the anti-fraud provisions are generally addressed through risk factors and other disclosures typically contained in a private placement memorandum. Offering documents will need to be carefully reviewed for material misstatements or omissions, which can give rise to significant liability on the part of the issuer, parties controlling the issuer and other participants in the offering.
- **Regulation of sales personnel** -Sales personnel involved in the offering of a security are regulated pursuant to both federal and state law. As discussed below, in the case of condominium hotel securities, state real estate brokerage and sales regulations would also be applicable.
- **Public reporting requirements** - A project with over 2,000 registered owners (or 500 owners who are not accredited investors) at the end of a fiscal year would become subject to periodic SEC reporting requirements and other federal

securities law obligations (including certain obligations arising under the Sarbanes-Oxley Act). In larger projects, by-law provisions or contractual mechanisms would be needed to address this contingency.

- **Restricted securities -** Despite the SEC's relaxation of the general solicitation and advertising rules, securities sold pursuant to Rule 506 – including those sold in a Rule 506(c) offering – are "restricted securities" for purposes of Rule 144, which it is prudent to conform to in most instances when reselling securities acquired in unregistered transactions. In general, the purchaser of an individual condominium unit who is unaffiliated with the issuer would be able to resell the unit freely after the expiration of a one-year holding period, and subsequent unaffiliated holders would be able to resell freely without any holding period. Prior to the expiration of the initial one-year holding period, the unaffiliated unit owner could resell the purchased unit in a valid private placement.[5] Private resales during the holding period might not be practical, however, because Rule 506(c) does not give resellers (as opposed to issuers) the ability to engage in general solicitation, and traditional resale methods, such as newspaper advertising and real estate listings, would presumably be unavailable.

## Securities brokerage registration and licensing requirements

Because the offering of a condominium hotel unit as a security is an offering of both real estate and securities, the legal requirements applicable to the sale of both apply. One approach to addressing the two sets of regulatory obligations would be to engage both licensed real estate brokers and licensed securities sales personnel (or "registered representatives") to participate in the offering. There is uncertainty, however, as to the sales procedures required to comply with both sets of legal

requirements, and the compensation arrangements that are permissible, if the sales effort utilizes separately licensed real estate and securities sales personnel. While it is possible that the issues that arise in this context can be managed in a way that presents an acceptable risk profile to all involved, utilizing dual-licensed sales representatives is likely to be the preferable approach.

Although dual licensing is not presently common, it is reasonable to anticipate that the opportunities presented by Rule 506(c) offerings will motivate real estate sales organizations offering “for sale” transient real estate products to engage dual-licensed agents. Some of these organizations may choose to form or acquire a registered broker-dealer in order to more closely control, and have continuous access to, dual licensed agents. Such a development would benefit the market given that the offering of condominium hotel securities would involve specialized considerations that could be most efficiently addressed by a real estate oriented broker-dealer. Until dual-licensed sales representatives become more commonplace, developers will need to explore the issues associated with the use of separate real estate and securities salespeople and evaluate the challenges presented.

It is typical for a securities broker-dealer to request an indemnity from the issuer of securities in the offering, and in the case of an offering of condominium hotel securities, it should be assumed that this indemnity would come from the developer or an affiliated entity. In this context, the developer would be expected to provide assurances as to the credit support behind the indemnity. It seems reasonable to argue that the value of the rental program operation, i.e., the front desk, provides adequate credit support as a result of the mandatory nature of rental program participation which assures rooms inventory and, therefore, operating cash flow. Nevertheless, this is a material issue that will need to be evaluated in making a decision to offer condominium hotel units as securities.

## Controlling person liability

Under the federal securities laws, a controlling person may be held liable for the actions of the sponsor, the issuer in a securities offering, subject to certain statutory defenses. In the context of a condominium hotel project, controlling persons would generally include the developer and its general partners/managing members (and their principals) and could also include other project participants. Controlling person liability could arise from misstatements and omissions in the offering memorandum as well as any deficiency in perfecting the private placement exemption under which the offering proceeds. While controlling person liability is an important issue that needs to be explored carefully with securities counsel and project insurance professionals, it ultimately may not represent a risk that extends well beyond existing exposure under other legal theories that may result in parent company liability.

## Conclusion

The potential to offer condominium hotel units as securities effects a radical change in the use of a condominium hotel structure where it is desirable to offer a “for sale” transient real estate product to the market. The engagement of a broker-dealer with properly licensed securities sales personnel is a logistical issue that will be susceptible to evaluation in relatively short order as the first few developers pursue this structure. It seems reasonable to anticipate, in this regard, that the market will meet the requirements of an offering structure with the advantages discussed above. Assuming the market does respond with appropriate securities sales capabilities, the sale of transient rental real estate under a Rule 506(c) structure should meet the needs of many developers.

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[1] Release No. 33-5347: Offer and Sales of Condominiums or Units in a Real Estate

Development.

[2] "Accredited investors" include individuals whose net worth (excluding positive net worth, but including negative net worth, in the individual's primary residence), or joint net worth with the individual's spouse, exceeds $1,000,000 or who had income in excess of $200,000 (or joint income with the individual's spouse in excess of $300,000) in each of the most recent two years and has a reasonable expectation of reaching the same income level in the current year.

[3] The accredited investor tests are likely to be revised in the future as a consequence of the SEC's mandate under Dodd- Frank to regularly evaluate the accredited investor standards as they relate to natural persons. The SEC is currently conducting a review that includes within its scope the consideration of whether income and net worth tests are the appropriate tests for accredited investor status. It should not be assumed, however, that any revision of the accredited investor definition would decrease the aggregate pool of accredited investors.

[4] If units are offered in or from New York, additional state filings and sponsor-related disclosures would be required.

[5] Importantly, in order for a resale to be permissible without the unit owner being considered to be an underwriter and take on (and potentially expose the sponsor to) additional securities law liabilities, the unit owner would have to acquire the unit without an intention to engage in a "distribution". We expect that purchasers in a Rule 506(c) offering of condominium hotel units would make traditional private placement representations confirming that the units were being acquired for investment/personal use and not with a view toward distribution.