



## The SEC is Watching Your Condo Hotel Deal

by Jim Butler

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**D**evelopers—whether developers of hotels or developers of condos—are experienced in dealing with a host of federal, state and regulatory agencies. But for most of them, the Securities and Exchange Commission (SEC) is not on the list. Imagine their surprise when they learn that SEC regulations will impact every aspect of structuring a successful condo hotel regime, as well as the sales and marketing of their condos.

### Why does the SEC care about condo hotels?

The SEC may view the condo offering as a “security,” if any one of the following exists:

1) The condo is sold to the buyer based on economic (or tax) benefits derived from participating in a management program; 2) the condo is put into a rental pool, where income and expenses are pooled and each condo owner gets an allocated share; 3) the unit owner has substantial restrictions on use, occupancy or selection of a rental agent of the owner’s choosing, or 4) is required to enter into a rental agreement. Because a successful condo hotel must have an adequate and predictable inventory of rooms to rent out to hotel guests, it is easy to see how these factors could present challenges.

### Developers Beware

“Fine, let’s get our lawyers to do the necessary paperwork for the SEC,” might be a reasonable response from a developer used to navigating a maze of government requirements. But developers should beware: Once an “investment” is a “security” it is regulated like a stock, with major consequences that will affect the project—and the developer—forever. First, the condo security must be registered with the SEC *and in every state where it is offered* (or be offered in strict accordance with restrictive exemptions from the registration requirements). Second, a securities

broker dealer (not a real estate broker) must sell the condos. Finally, because of the SEC’s anti-fraud rules, it is much easier for a dissatisfied “investor” to sue the developer, and the developer can be held personally responsible for non-compliance.

But whether developers elect to structure the condo hotel project as a “security” or seek to avoid security status (and most do the latter), the complexities remain and will affect just about every aspect of the condo hotel project, including its legal and financial structure, its sales staff and marketing literature, and even the hotel operations. And all this must be considered and carefully implemented before even one unit is sold, as it is nearly impossible to “fix” deficiencies after sales commence.

### The Rules of the Game

So if most developers structure their condo hotel projects to avoid “security” status, what kinds of limitations does that decision impose on a condo hotel sales program? Here are just a few of the highlights, which must be dealt with:

- Participation in a rental management program cannot be mandatory and cannot under any circumstances include pooling of revenue or expenses.
- The only thing condo sales literature can say about the rental program is “Ownership may include the opportunity to place your home in a rental arrangement.”
- Condo sales personnel cannot bring up the rental program unless the buyer inquires, and then they must refer an interested buyer to the separate rental program staff.
- The sales staff must be separate from the rental program staff.

Jim Butler

JEFFER, MANGELS, BUTLER & MARMARO LLP

1900 Avenue of the Stars, 7<sup>th</sup> Floor, Los Angeles, CA 90067 ♦ (310) 201-3526 ♦ (310) 712-8526 fax ♦ jbutler@jmbm.com

- No one and no materials can discuss economic or tax benefits from the rental arrangement.
- No economic projections based on renting the condo can be made.
- Neither comparables nor values can be made available by the real estate sales staff.
- Rental program staff can discuss comparables and values, but only in response to a direct request from the buyer, and then only raw data can be provided.
- Buyers must be free to use the services of other rental agents, or rent out their unit themselves.
- No rental management agreement can be entered into before the buyer has purchased the unit.
- Rental management agreements must have term limits, perhaps 3-5 years.

### **Making It Work in the Real World**

While it is one thing for a developer to understand and embrace these guidelines, it is another thing entirely to control the enthusiasm of sales reps hired to sell the condos. Mandatory, ongoing training programs for sales

people must be implemented and documented. A policy of “zero tolerance” for errors in judgment must be enforced. Every purchase contract should include a signed acknowledgement, by the buyer, that the rental program was not used as an inducement to buy, and that no economic projections were provided by the seller. Full compliance in these areas is critical, as we can all count on the inevitable: lawsuits by condo owners claiming their developers violated securities law.

**A**nd perhaps the greatest challenge is structuring the condo hotel regime as a viable operating hotel. With all the securities implications, this takes a complex series of carrots and sticks to incentivize condo owners to participate in the rental program, and to make their condo association work with the operating hotel standards. Generally, this requires an expert team who knows how to accommodate all of these considerations and many others and weave them into the CC&Rs, Home Owner Association (HOA) documents, rental management agreements, and hotel operating agreements. When called upon to “fix” traditional documents prepared by experienced condo counsel used to dealing with traditional condominium projects, we generally have to throw them away and start from scratch to handle the unique challenges of a condo hotel regime.



**Jim Butler** is recognized as one of the top hotel lawyers in the world. He devotes 100% of his practice to hospitality, representing hotel owners, developers and lenders. Jim leads the Global Hospitality Group—a team of 50 seasoned professionals with more than \$35 billion of hotel transactional experience, involving more than 1,000 properties located around the globe. They are more than “just” great hotel lawyers. They are also hospitality consultants and business advisors. Through the practical experience of more than 36 condo hotel projects in the United States and Latin America, the Global Hospitality Group has distilled the best aspects of earlier projects and advanced the “cutting edge technology” to find better solutions to many condo hotel issues. Jim Butler is a

Founding Partner of Jeffer, Mangels, Butler & Marmaro LLP and he is Chairman of the firm’s Global Hospitality Group. If you would like to discuss any hospitality or condo hotel matters, Jim would like to hear from you. Contact him at [jbutler@jmbm.com](mailto:jbutler@jmbm.com) or 310.201.3526.

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*Jim Butler*

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1900 Avenue of the Stars, 7<sup>th</sup> Floor, Los Angeles, CA 90067 ♦ (310) 201-3526 ♦ (310) 712-8526 fax ♦ [jbutler@jmbm.com](mailto:jbutler@jmbm.com)