

## **The Applicability of Securities Laws to Condo Hotels**

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### **General – The Condominium/Hotel Structure**

Condominium hotels, or “condo hotels”<sup>2</sup>, are not new, but have enjoyed increasing popularity recently in the hospitality industry. A “condo hotel” generally encompasses any arrangement in which condominiums, units owned in fee simple or in some cases as leaseholds or cooperatives, are combined into a hotel development. The term “condo hotel” has been applied to a wide spectrum of arrangements, ranging from a development in which condominiums located in a hotel development are used solely for residential purposes and have little or no interaction with hotel operations, to arrangements in which condominiums are an integral and seamless part of the hotel operation. Condo hotel unit owners generally may (i) rent their units on their own or through a third-party rental agent; or (ii) participate in a rental program, administered by the developer or its management company, pursuant to which time in the condo hotel unit is rented to the general public in the same manner as traditional hotel rooms. Condo hotel unit owners often retain a portion of the time for their own use. The developer usually retains ownership of the common areas and structural components of the hotel.

The appeal of a properly structured condo hotel development from a developer’s perspective is easy to see – in a time of tight financing for pure hotel developments, a significant portion of construction and development costs can be “outsourced” through sales of condominiums in the development. Units in the condominium component of a condo hotel are generally marketable at a premium over traditional condominium developments, due to the value added by hotel amenities (such as room service, housekeeping, access to hotel facilities, and as discussed below, the opportunity to participate in rental programs).<sup>3</sup>

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<sup>1</sup> The author gratefully acknowledges the contributions of Morris Ellison to this article.

<sup>2</sup> For purposes of the possible application of the securities laws, the actual structure is immaterial and covers even wider ground (for example, resort condominiums in which there is no hotel component, conversions of hotels or apartments into condominiums, and even exclusive-occupancy agreements covering residences on luxury passenger ships). Federal and state securities laws may apply to any arrangement in which the sale of a conventional real estate interest (such as a condominium) is coupled together with a rental program. See discussion at notes 4 – 7, *supra*.

<sup>3</sup> See Ernst & Young LLP, *Hospitality Industry’s Top 10 Thoughts for 2005*, available at <http://www.hospitalitynet.org/news/154000320/4021857.html> (Jan.19, 2005); *Condo hotel Phenomenon Reaches New Heights*, [hotelbusiness.com](http://hotelbusiness.com) (March 14, 2005). The popularity of condo hotels has spread to cities and resort locations across the United States, including the greater Seattle area, where at least five such projects are currently in development. See Elizabeth Rhodes, *The Appeal of Having Everything Just Steps Away*, *The Seattle Times* (April 3, 2005 at p. G-1).

## Application of Securities Laws

To the surprise of some developers, the offer and sale of condominium units in a condo hotel arrangement can constitute the offer and sale of “securities,” subject to both federal and state securities laws. Securities laws can potentially apply in any instance in which interests in real estate are sold in conjunction with a rental arrangement for the periods during which the unit owners will not be residing in the unit.

The ordinary purchase of a home or condominium is not, obviously, within the scope of the securities laws. In such a transaction, the purchaser intends to occupy the acquired property, hold it for appreciation, or perhaps rent it to others. The purchaser does not expect the seller or any third party to do anything, after the purchase, to increase the property’s value or otherwise provide him or her with profits.

This is not always the case when the acquired property is offered and sold together with a rental agreement, where the property developer or an affiliate undertakes to rent the property for the owner when he or she is not using it. Depending on the structure of the arrangement (such as a pooling of rentals with other participants) and the representations made to the purchaser in the sales process (such as the possibility of profit resulting from the rental program), at some point the purchaser is no longer simply *purchasing* real estate but is instead *investing* in a business enterprise, with the return dependent on the managerial efforts of others. At this point the purchaser is acquiring a “security.”

Developers will nearly always want to avoid having sales of condo hotel interests characterized as an offering of securities. Among other things, registering securities is a costly and time-consuming process. Even if the offer and sale is registered or exempt<sup>4</sup> from registration, unit purchasers have additional remedies, including claims based on misrepresentation or fraud<sup>5</sup> under the securities laws. Salespersons involved in the offer and sale of securities will generally need to be registered as broker-dealers.

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<sup>4</sup> Federal securities laws provide limited exemptions from the registration requirement of the Securities Act of 1933 (the “1933 Act”) if an offering is deemed to be the offering of “securities.” Each available exemption contains significant disadvantages in the context of sales of condo hotel interests. The most commonly used exemption is known as a “Regulation D” offering.” At the federal level, Regulation D prohibits any form of general solicitation or general advertising, limits the number of purchasers who are not “accredited investors,” and requires that substantial written disclosure (including risk factors, etc.) be provided to all purchasers who are not accredited investors. Further, because interests sold under Regulation D are unregistered (exempt) securities, they may not be resold unless an exemption from registration is available. Securities sales can also be exempt under Section 3(11) of the 1933 Act if they are offered and sold only to persons resident within a single state, where the issuer is organized in and doing business, but this “intrastate exemption” is strictly construed and can involve significant restrictions on a purchaser’s ability to resell the security. The remedy for sales of unregistered securities that do not qualify for an exemption is typically rescission (an offer to repurchase the interests of all purchasers, at the original purchase price plus statutory interest). In effect, the purchaser of an unregistered security makes his or her investment with a “put” for a term equal to the statute of limitations under the 1933 Act of two years, *see* 15 U.S.C. § 77c(a)(11) (2005), or the applicable state specific statute of limitations.

<sup>5</sup> Independent of the issue of exemption from registration, the securities laws also prohibit the use of “manipulative and deceptive practices” in connection with the sale of securities. This is broadly defined as the making of an untrue

The first step in avoiding application of the securities laws in the condo hotel context is identifying the circumstances in which the securities laws might apply:

- NOT a security: Sale of a condominium unit, with no related rental program.
- VERY LIKELY a security: Sale of a condominium unit together with a mandatory rental agreement with the developer or an affiliate, and heavy emphasis during the sales process on the likely economic benefits of the rental program.
- GRAY AREA: Everything in between these two examples.

### **The Challenge**

As discussed in more detail below, certain of the criteria that could cause condo hotel interests to constitute securities are relatively straightforward, and can be addressed and avoided by properly structuring the rental management program. The primary challenge is in the sales area. Under SEC guidelines, very little can be said about the potential economic aspects of a rental program, and only in specific circumstances. However, for many prospective purchasers the economics of the rental program are an important factor in the purchase decision. Real estate salespersons, whose objective is to close the sale, will generally be inclined to provide as much (positive) information as possible. Properly managing these competing requirements and interests requires the careful attention of the developer and the developer's counsel.

### **Scope of Article**

This article discusses the U.S. Supreme Court decision that established the factors applied to determine the existence of a security, and the SEC's later release applying such factors to offers of condominiums with collateral rental arrangements. Several SEC no-action letters will also be discussed in order to provide guidance as to the current state of the SEC's view of condo hotel offerings as securities. Although SEC no-action letters apply only to the specific facts presented to the SEC in each no-action request, these letters provide guidance as to factors that the SEC considers important. Finally, a list of practical considerations applicable to the structuring of rental and sales programs is provided.

### **The Howey Decision**

In 1946, the United States Supreme Court issued its opinion in the seminal case of SEC v. W.J. Howey Co.<sup>6</sup> The application of the securities laws by the Supreme Court in Howey may have surprised the promoter as much as some developers are surprised that they may apply to real estate sales, as the case did not deal with traditional securities. The promoter sold tracts in Florida citrus groves to investors. Investors were advised that the purchase was not

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statement of a material fact, or omitting to state a material fact necessary to make the statements made, in light of the circumstances, not misleading. Remedies under the federal "anti-fraud" provisions can include treble damages and attorneys' fees.

<sup>6</sup> SEC v. Howey, 328 U.S. 293 (1946).

economically feasible unless they also entered into a service contract with an affiliate of the promoter. Under the service contract, the affiliate provided services in cultivating, developing, harvesting and marketing the crops produced in the tracts, with the net profits distributed to the investors/tract owners. The Howey decision sets forth the characteristics of an “investment contract,” which is one of the types of security covered by the Securities Act of 1933, as amended. The Court in Howey focused on the “economic realities” of the investment, and held that an interest (for example, a real estate interest) will be considered to be a security if all of the following elements are present:

- an investment of money;
- in a common enterprise; and
- the expectation of profits solely from the efforts of the promoter or a third party<sup>7</sup>

Although the Howey test has served as the basis for determining the existence of an investment contract for federal securities law purposes since its issuance, and is applied by most states, a significant minority of states follow a somewhat different standard.<sup>8</sup>

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<sup>7</sup> The requirement that the expectation of profits be based “solely” from the efforts of others was modified in SEC v. Glenn Turner Enters., Inc., 474 F. 2d 476 (9<sup>th</sup> Cir. 1973) to encompass profits based substantially from the efforts of others. The Glenn Turner court held that the “solely” requirement of Howey was satisfied when those other than the investor make the essential managerial decisions that affect the success or failure of the enterprise. *See also* the 1973 Release.

<sup>8</sup> Commissioner of Securities v. Hawaii Market Center, Inc., 458 P. 2<sup>d</sup> 105 (1971). The decision in Hawaii Market Center set forth a four-part test with a slightly different focus than the Howey test. An investment contract will be found to exist where (i) an offeree furnishes initial value to an offeror; (ii) a portion of the investment is subject to the risks of the enterprise; (iii) the furnishing of the initial value is induced by the offeror’s promises or representations, which give rise to a reasonable understanding that valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise; and (iv) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

## The SEC's 1973 Condominium Release

The SEC first directly addressed the possible applicability of the securities laws to the offer and sale of condominium units in 1973<sup>9</sup> (the "1973 Release"). The 1973 Release acknowledges that "there is uncertainty about when offerings of condominiums and other types of similar units<sup>10</sup> may be considered to be offerings of securities" and provides guidelines for analysis. Given the passage of time, however, the real source for guidance in this area is both the 1973 Release and the series of SEC no-action letters released after the 1973 Release.

Focusing primarily on the third prong of the Howey test ("expectation of profits"), the 1973 Release notes that "the 'profits' that the purchaser is led to expect may consist of revenues from rental of the unit; these revenues and any tax benefits resulting from rental of the unit are the economic inducements held out to the purchaser." The presence of various kinds of "collateral arrangements" in the sale of condominium units indicates that the promoter "is offering an opportunity through which the purchaser may earn a return on his investment through the managerial efforts of the promoters or a third party in their operation of the enterprise."

The 1973 Release notes that some public offerings of condominium units involved rental pool arrangements, in which the promoter or a third party undertakes to rent the unit on behalf of the owner when not in use by the owner, and rents received and the expenses of renting all of the units in the project are combined, with the individual owner receiving a ratable share of the rental proceeds, regardless of whether his individual unit was actually rented. The offer of a unit together with an opportunity to participate in such an arrangement, the 1973 Release states, is the offer of an "investment contract" and thus a security.

The 1973 Release also notes that condominium units may be offered with a contract or agreement that places restrictions on the use of the condominium unit. Restrictions may include (i) requiring the use of an exclusive rental agent; (ii) limitations on the period of time the owner may occupy the unit; and (iii) limitations on the purchaser's occupancy or rental of the property purchased. These restrictions "suggest that that the purchaser is in fact investing in a business enterprise, the return from which will be substantially dependent on the success of the managerial efforts of other persons." Thus the offer of condominium units with such restrictions is the offer of an "investment contract" and thus a security.<sup>11</sup>

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<sup>9</sup> SEC Release No. 33-5347, dated January 4, 1973.

<sup>10</sup> The 1973 Release notes that "resort condominiums are one of the more common interests in real estate the offer of which may involve an offering of securities. However, other types of units that are part of a development or project present analogous questions under the federal securities laws. Although this release speaks in terms of condominiums, it applies to offerings of all types of units in real estate developments which have similar characteristics to those described herein."

<sup>11</sup> See footnote 18 and accompanying text.

Lastly, the 1973 Release addresses more generally the sale of condominium units that are coupled with “collateral arrangements” of any kind. In such circumstances, the “manner of offering and economic inducements held out to the purchaser” plays an important role in determining whether the offering involves a security. The 1973 Release states that condominiums coupled with a rental arrangement “will be deemed to be securities if they are offered or sold through advertising, sales literature, promotional schemes or oral representations which emphasize the economic benefits to the purchaser” to be derived from the promoter’s or a third party’s managerial efforts.

As the “manner of sale” factor focuses only on inducements to purchase the condominium unit, the 1973 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, whether or not such agent is affiliated with the offeror” without causing the sale of a security to be involved.

The 1973 Release thus provides the following guidelines to a developer who desires to avoid the application of the securities laws to sales of interests in condo hotel programs:

- Do not offer a rental arrangement that provides for the pooling of rental revenues;
- Do not place significant restrictions on the purchaser’s use of the condominium unit; and
- Do not emphasize the economic benefits of a rental agreement or similar collateral arrangement.

Assuming that the offer and sale of the unit complies with these restrictions, a purchaser may enter into a voluntary rental agreement after his or her purchase.

### **The Intrawest No-Action Letter**

A promoter’s ability to disclose rental programs, and the timing of the execution of a rental agreement in connection with a condominium sale, were addressed, and previous restrictions somewhat loosened, in the SEC no-action letter *Intrawest Corporation*, 2002 WL 31626919 (available November 8, 2002). Intrawest was a large developer of resort condominiums. According to Intrawest’s no-action request, over 80% of condominium purchasers place their units, after purchase, in some form of rental agreement and over 90% of such persons choose Intrawest for rental management.

The Intrawest request notes that typical resort condominium purchasers are “overwhelmingly people who seek to enjoy personal use from the property and view the ability to derive rental income as a means of financing the purchase and continued ownership.” As a result, potential purchasers often sought from Intrawest, as the seller, information about rental possibilities, as this information would be necessary to make an informed decision about purchasing a unit.

Prior to the Intrawest no-action letter, the SEC had indicated in response to several no-action requests<sup>12</sup> that discussions with prospective purchasers regarding a rental program offered by a promoter or its affiliate should only occur in response to a specific request. Although agreeing with the SEC's policy that developers should not emphasize potential profits from a rental arrangement, Intrawest characterized this "don't ask don't tell" requirement as taking such policy to an illogical extreme, given that rental during periods of the unit owner's absence are an integral part of the purchase decision.

Intrawest requested the SEC's agreement that its proposed marketing program, as it involved rental arrangements, did not cause the offer and sale of the units to constitute an offering of securities. Intrawest's proposed marketing program had the following features:

- Intrawest sales personnel were allowed to mention the rental management program as one of the many optional services available to unit owners. This mention (in both written and oral promotional materials) was limited to the following statement: "Ownership may include the opportunity to place your home in a rental arrangement."
- If a prospective purchaser desired more information, the real estate salesperson would suggest that he or she speak to a rental management company representative, either with Intrawest's affiliated management company or an unaffiliated management company of his or her choice.
- Under no circumstances would sales materials or the real estate salesperson discuss the economic or tax benefits that might result from entering into a rental arrangement.
- Real estate salespersons would not provide prospective purchasers with information, including publicly available information, regarding the rental history of comparable facilities in the area.
- Any information regarding the rental history of comparable facilities would only be provided by representatives of the rental management company, and then only in response to a specific inquiry. No projections of future rental income or expected occupancy rates would be provided. Any information provided would be in the form of raw data that had not been modified by sampling, statistical analysis or by any other means.
- To ensure that real estate sales representatives did not improperly disclose rental information to prospective purchasers, the real estate sales representatives and rental company representatives would not overlap and each operation would be run independently. Real estate salespersons would not receive additional compensation or other incentives for unit sales to persons who also entered into rental management agreements with Intrawest or an affiliate.

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<sup>12</sup> See *FC Beach Joint Venture*, SEC No-Action Letter, 1998 WL 278529 (May 29, 1998); *Princeville Corp.*, SEC No-Action Letter, 1991 WL 178578 (March 13, 1991).

- Intrawest would take precautions necessary to ensure that its real estate salespersons limited their discussion of rental arrangements to the phrase quoted above, and that representatives of its rental management company would only provide information in response to specific inquiry.

Intrawest stated that it intended to contract with one or more nationally known hotel chains to provide rental management services. Intrawest stated that if a purchaser inquired about rental opportunities, Intrawest would inform the purchaser that he or she was free to use the services of any rental management company, and that Intrawest would not prevent or discourage owners from renting units themselves or using the services of unaffiliated rental management companies.

Intrawest also noted that its rental management office was expected to be on-site and perhaps in close proximity to the sales office. The SEC had indicated in previous no-action letters that a small degree of physical separation between these offices would be acceptable.<sup>13</sup>

The SEC adopted a “no action” position to the proposed Intrawest sales program.

The Intrawest no-action letter also addressed the timing of the execution of a rental agreement. The 1973 Release had stated that “an owner of a condominium unit may, *after* purchasing his unit, enter into a non-pooled rental arrangement...” (emphasis added). The SEC had stated in a subsequent no-action letter<sup>14</sup> that entering into a rental agreement after the purchase and sale agreement had been executed but prior to closing was unacceptable. The Intrawest no-action letter modifies this position.

Intrawest stated that it would not discuss the terms of, or agree to enter into, rental management agreements with individuals until a purchase and sale agreement had been executed, but that it might do so prior to closing. Intrawest pointed out that upon entering into a purchase and sale agreement, a purchaser was required to pay a non-refundable deposit equal to 10% to 20% of the purchase price, and that consequently the decision and commitment to purchase a unit had been made at that point, notwithstanding that the actual closing might not occur for several weeks or months. Intrawest proposed, and the SEC accepted, the execution of a rental management agreement after the execution of the purchase and sale agreement and prior to the closing on the unit. The effectiveness of the rental management agreement would in all cases be contingent upon the closing of the sale of the applicable unit.

### **Structuring a Sales and Rental Management Program**

In structuring a condo hotel sales program and related rental management agreement based on the SEC’s guidance, it is useful to consider the three prongs of the requirements of the 1973 Release, as they have been developed through subsequent no-action letters:

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<sup>13</sup> See *Marco Polo Hotel, Inc.* (available October 30, 1987).

<sup>14</sup> *FC Beach Joint Venture* (available May 29, 1998).

## Prong No. 1 – Pooling of Revenues

- This requirement is relatively straightforward. A developer cannot offer rental arrangements that provide for the pooling of rental revenues. Rental arrangements should provide that a unit owner’s rental revenue is based on actual net revenues from rental of his or her unit.<sup>15 16</sup>

## Prong No. 2 – Restrictions on Use of Unit

- A developer cannot require a unit purchaser to enter into a rental management agreement. A purchaser desiring to enter into a rental management agreement must be free to use the rental management company of his or her choosing.
- The rental management agreement must not materially restrict the owner in the occupancy or rental of his or her unit.<sup>17 18</sup> Generally speaking the owner should have

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<sup>15</sup> The pooling of rental income is not absolutely prohibited under all circumstances, but cannot be offered as part of the original rental program. Despite the literal language of the 1973 Release (“the owner of a condominium unit may, after purchasing his unit, enter into a *non-pooled* rental arrangement”)(emphasis added), the SEC has taken no-action positions in several instances in which the condominium owners had the right, after purchase and without the involvement of the developer, to enter into pooled arrangements. For example, in *International Investment Properties, Inc.*, SEC No-Action Letter, 1995 WL 451934 (July 28, 1995), the SEC favorably responded in a situation in which the developer had no role in property management and any decision to pool rental revenues was made by unit owners after purchases. The no-action request stated that under the condominium declaration, with the approval of a predetermined percentage of unit owners, property management “may include a pooling of any income generated by the collective rental of the condominium units.” The condominium board would have the right to terminate the pooling arrangement at any time, or to replace the management company responsible for its implementation. Unit owners would be provided with the flexibility to choose to participate or withdraw from the arrangement at any time. Any collective rental pooling arrangement would be offered on a optional and non-exclusive basis, so that each owner would be free to retain another company or individual to manage his unit, or to withdraw the unit entirely from the rental market. Similar results were reached in *Recreational Industries, Inc.*, SEC No-Action Letter, 1987 WL 107952 (Apr. 20, 1987); *Sunrise Terrace Trust*, SEC No-Action Letter, 1986 WL 65174 (Feb. 10, 1986); and *Terrace Hill Condominium*, SEC No-Action Letter, 1983 WL 28696 (Sep. 29, 1983). Notwithstanding the SEC’s position, at least one developer (see *FC Beach Joint Venture*, SEC No-Action Letter, 1998 WL 278529 (May 29, 1998)) stated that its recorded condominium hotel documents barred pooling of rental revenues, which appears to be an unnecessary precaution.

<sup>16</sup> The SEC has indicated that a system of rotational rental unit assignments that was intended to promote the fair allocation of rental units in a condo hotel development does not constitute a “pooling arrangement” within the meaning of the 1973 Release. See *One Central Park West PT Associates* (available November 2, 1995); *Hammock Dunes Condominium* (available February 21, 1989).

<sup>17</sup> A rental management agreement offered by the promoter or an affiliate, even if voluntarily entered into by the unit owner, could potentially be considered a material restriction if its term is unduly long or if it is unduly difficult to terminate. The term of rental management agreements in the no-action requests cited in this article is typically three to five years, although at least one developer (in *FC Beach Joint Ventures*, available May 29, 1998) offered both a five and a ten-year term. Developers seeking no-action letters typically provide business reasons for the length of the agreement, such as a need to assure a stable number of units in the rental program, or to assure adequate room availability for conventions, which may be scheduled years in advance. The unit owner should have the ability to terminate the rental management agreement prior to the end of the term, at least upon a default by the rental management company or in the event a bankruptcy proceeding is instituted by or against the rental management company. (See *Intrawest*).

unlimited freedom to use and occupy the unit at any time and for any length of time desired, subject only to prior reservations booked by the rental management company and related notice requirements allowing for the efficient implementation of the rental management program.<sup>19</sup>

### **Prong No. 3 – No Emphasis on Economic Benefits**

- The sales program should emphasize the benefits of the unit as real estate, not as an investment. Promotional material should stress the factors normally associated with real estate sales; location, construction quality, lifestyle, tax benefits associated with mortgage interest deductions, and similar factors. No representations should be made regarding the economic benefits of unit ownership.<sup>20</sup>
- A developer cannot require a unit purchaser to enter into a rental management agreement. Additionally, a purchaser who desires to enter into a rental management agreement must be free to use the management company of his or her choosing.
- All sales and promotional materials should be reviewed by counsel.

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<sup>18</sup> The 1973 Release addresses the “offering” of condominium units in conjunction with (among other things) the offering of a rental or similar arrangement whereby the purchaser is materially restricted in his occupancy or rental of his unit, stating that such arrangements “suggest that the purchaser is in fact investing in a business enterprise....” Virtually all of the no-action requests cited in this article refer to rental programs that contain minimal restrictions on use of the unit. Two commentators have suggested, however, that if the unit owner’s decision to use the program is voluntary, and occurs after the sale of the unit, the rental agreement could limit or prohibit the owner’s use of the unit, and that such restrictions are ultimately limited by marketing considerations. (see Butler & Maisnik, *Urban Land Magazine* by the Urban Land Institute, February 2005).

<sup>19</sup> In a number of no-action letters, the SEC has concluded that restrictions imposed by zoning regulations, local ordinances and building codes do not constitute material restrictions that would cause the sale of the units to constitute sales of securities. *One Central Park West PT Associates*, available November 2, 1995; *Marco Polo Hotel, Inc.* (amended request, available November 29, 1988); *The Dolphin of Virginia Beach, Incorporated*, available December 9, 1983; *The Atrium Condominium*, available January 27, 1984).

<sup>20</sup> It is clear that no representations whatsoever may be made regarding the potential economic benefits of participation in a rental program or through other managerial efforts of others. Although less clear, it appears that economic benefits associated with the unit’s potential appreciation in value can be discussed. Potential capital appreciation is a feature of real estate ownership generally, and at least one no-action letter was issued where the promoter indicated that its salesmen are “free to respond to questions related to general appreciation in real estate” and its sales campaign may “include...information with respect to the appreciation in value of the Units as well as the deductibility of payments of interest...which are typical as a part of the ownership of real property.” *Marco Polo Hotel, Inc.* (available October 30, 1987). See also *Recreational Industries, Inc.* (available April 20, 1987). In its response to both no-action requests, the SEC stated that the units should be sold “without any emphasis on the economic benefits to the purchaser to be derived either from the managerial efforts of others or from the rental of the units.” In its no-action response in *FC Beach Joint Ventures* (available May 29, 1998) the SEC, without elaboration, added to the foregoing the following limitation on offers and sales: “[No] representations will be made with regard to the economic or tax benefits of ownership of the Units.” Despite the broader scope of this prohibition, it should be noted that the subsequent *Intrawest* no-action request stated that no purchaser would be led to believe that he would profit from the ownership of the units “by any means other than the appreciation in value of the property.”

- The developer must carefully train and closely monitor real estate salespersons and affiliated rental management company representatives.<sup>21</sup> While in many real estate sales, one hears the watchword, “location, location, location,” in the context of the offering of condo hotel units, the developer must focus on “training, training, training.”
- The developer should operate its real estate sales efforts and rental management program separately, with no overlap of employees and some physical separation of offices. The office for the developer sponsored rental program may be located on the same site as the sales office, but the two offices should be physically separated.<sup>22</sup>
- Real estate salespersons should not be compensated for rental agreements entered into by condominium purchasers.
- Whether in oral discussions with prospective purchasers or in promotional materials, the developer’s representative should say no more than “Ownership may include the opportunity to place your condominium in a rental arrangement.”
- In response to a prospective purchaser’s request for more information regarding rental arrangements, the real estate salesperson should suggest that the individual speak to a rental management company representative (either affiliated with the promoter or an unaffiliated company of the purchaser’s choosing).
- The rental management company representative may, in response to a specific inquiry from the prospective purchaser, provide information regarding rental histories of comparable properties. Any such information must be limited to “raw data.”<sup>23</sup> Only the

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<sup>21</sup> The importance of staff training and supervision cannot be overemphasized. A developer’s responsibility for statements made by sales personnel is absolute, in the sense that it is not enough to merely demonstrate that procedures have been established to avoid representations that violate the securities laws. The following is typical of the language contained in SEC no-action responses: “[the] Division wishes to emphasize that the offer and sale of condominium properties and similar properties often involves oral representations made to potential purchasers by sales persons. . . . In this regard, the Division wishes to make clear that the position expressed in this letter will no longer be applicable if any realtors or salesmen make oral representations regarding the [units] which differs from the representations contained in your letter.” *One Central Park West PT Associates* (available November 2, 1995).

<sup>22</sup> *Intrawest Corp.*, 2002 WL 31626919 at 2.

<sup>23</sup> The limitation of financial information to raw data (not modified by sampling, statistical analysis or any other means) regarding the rental history of comparable properties is an undertaking typically made in recent no-action requests (for example, see *Intrawest Corp.* and *FC Beach Joint Venture*). Some ambiguity as to this limitation exists, however, as reflected in the no-action position taken in *Planners Development Corporation of America* (available December 9, 1985). *Planners* involved an apartment complex converted into a condominium, where the sales presentation to prospective purchasers included “projections of income, cash flow, and tax consequence projections for ownership of a unit based upon factors which assume a stated income bracket, occupancy rate, appreciation rate and expense rate.” The *Planners* no-action request notes that although some purchasers were choose to live in their units, “it is anticipated that most purchasers will lease their Units to third parties and look to the Unit as a source of tax benefits and cash flow. Purchasers will in no way, however, be prevented or discouraged from occupying their Units.” The *Planners* no-action letter was cited in *Recreational Industries, Inc.* (available April 20, 1987) in which the developer of a condo hotel indicated that prospective purchasers would be provided with an information package that included “financial and tax projections based on the use of a unit as a rental

rental management company representative, not the real estate salesperson, may provide such data and then only in response to a direct inquiry. Projections of future rental income or expected occupancy should not be provided.<sup>24</sup>

- No one (neither the real estate representative nor the rental management company representative) may provide any projections of future rental income or expected occupancy rates.
- The purchaser of a condominium unit may enter into a rental management agreement, (i) after the execution of the purchase and sale agreement, but before closing if the agreement is contingent upon closing, or (ii) after closing.

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property.” In both *Planners* and *Recreational Industries* the SEC took a no-action position while stating that the units should be offered and sold “without any emphasis on the economic benefits to the purchaser to be derived ... from the rental of the units.” The SEC does not appear to have rescinded or overruled *Planners* or *Recreational Industries* in subsequent no-action letters, but given the undertakings made in *Intrawest, FC Beach Joint Ventures* (“no rental projections ... will be provided to prospective purchasers”) and other more recent no-action requests, an developer would be ill-advised to provide more than raw data regarding comparable properties without first seeking a no-action letter specifically addressing the issue.

<sup>24</sup> The limitation of financial information to raw data (not modified by sampling, statistical analysis or any other means) regarding the rental history of comparable properties is an undertaking typically made in recent no-action requests (see, e.g., *Intrawest Corp. and FC Beach Joint Venture*). Some ambiguity as to this limitation exists, however, as reflected in the no-action position taken in *Planners Dev. Corp. of Am.*, SEC No-Action Letter, 1985 WL 55678 (Dec. 9, 1985). *Planners* involved an apartment complex converted into a condominium, where the sales presentation to prospective purchasers included “projections of income, cash flow, and tax consequence projections for ownership of a unit based upon factors which assume a stated income bracket, occupancy rate, appreciation rate and expense rate.” The *Planners* no-action request notes that though some purchasers might choose to live in their units, “it is anticipated that most purchasers will lease their Units to third parties and look to the Unit as a source of tax benefits and cash flow. Purchasers will in no way, however, be prevented or discouraged from occupying their Units.” The *Planners* no-action letter was cited in *Recreational Industries, Inc.*, 1987 WL 107952, in which the developer of a condo hotel indicated that prospective purchasers would be provided with an information package that included “financial and tax projections based on the use of a unit as a rental property.” In both *Planners* and *Recreational Industries* the SEC took a no-action position while stating that the units should be offered and sold “without any emphasis on the economic benefits to the purchaser to be derived ... from the rental of the units.” The SEC does not appear to have rescinded or overruled *Planners* or *Recreational Industries* in subsequent no-action letters, but given the undertakings made in *Intrawest, FC Beach Joint Ventures* (“no rental projections ... will be provided to prospective purchasers”) and other more recent no-action requests, a developer would be ill-advised to provide more than raw data regarding comparable properties without first seeking a no-action letter specifically addressing the issue.

## Summary

Structuring a rental program to be offered in connection with units in a condo hotel requires careful attention in order to avoid application of the securities laws. Planning should begin in the earliest stages of development, and should include working with legal counsel to properly prepare rental agreements, contractual arrangements between the developer and the affiliated rental management company, and written promotional materials. Given the natural tension between the SEC's strict "manner of sale" prohibitions and the desire of many potential unit purchasers to obtain exactly the kind of information that is prohibited (specifically projected revenues from the rental program), meticulous care must be taken to train and supervise the sales staff, as a salesperson's statement, made to a prospective purchaser with a "wink and a nod," has the potential to undo an otherwise proper program, with dire results.

If you have additional questions regarding this area of the law, please contact Irv Sandman (206-340-9641, or [isandman@grahamdunn.com](mailto:isandman@grahamdunn.com)) or Bart Bartholdt (206-340-9647, or [bbartholdt@grahamdunn.com](mailto:bbartholdt@grahamdunn.com)).