The “new breed” of condominium hotels — Key to financing new hotel development? Selling condo hotels as “securities” under new SEC Rule 506(c).

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Condo hotel revolution and resurgence:
Why developers are using “new breed” of condo hotels for financing

One “little” legal change has revolutionized and revitalized condo hotels

by

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Condo Hotel Lawyers

The condo hotel lawyers at JMBM have helped clients with more than 100 condo hotels and hotel condos. Our experience proves that well-structured condo hotels play a valuable role and have earned an enduring legacy in the hospitality industry. They make new hotel development feasible where limited financing and high construction costs would otherwise be prohibitive. And now one recent legal change sweeps away some of the knotty issues that have hampered condo hotel growth, and reignites the popularity of this approach with a “new breed” of condo hotels.

We are now at a pivotal point for condo hotels. We are witnessing the complete turnaround in the way developers will structure condo hotel deals — particularly for high-end and luxury properties. This 180 degree turnaround in approach is creating a new and better breed of condo hotels that builds upon past successes and takes a giant step forward.

This was all accomplished with the stroke of a pen late last year when the Securities and Exchange Commission (SEC) adopted Rule 506(c) in response to the express requirements of the JOBS Act. The JOBS Act required the SEC to eliminate the prohibition on using “general solicitation” in private placements under Rule 506 where all the purchasers of the securities are “accredited investors.” Effectively, this single legal change has suddenly made it feasible for most hotel developers to structure and sell their condo hotel projects as “securities.”

This is a big change! Over the past 50 years or more, with only a few isolated exceptions, all condo hotel deals were tortured monstrosities of legal convolution. Because of the prior securities laws, it was not practical for most developers to have their offering be considered a “security” because it was not practical to register the securities with the SEC (as in an IPO), and general public solicitation is essential to the sale of real estate like condo hotel units. However, under the prior law, achieving the critical “non-security” status imposed some nonsensical legal requirements.
Most of these absurdities resulted from the fact that investors typically buy condo hotels as an investment and want the kind of information that would be relevant to making an intelligent investment decision. However the prior SEC rules effectively prevented developers from selling condo hotels as an investment with the relevant information and structure to provide the greatest prospects of success. This created the practical paradox that it was illegal for developers to sell condo hotels as an investment, but it was not illegal for buyers to purchase condo hotels as an investment (and most buyers did so).

Practical implications of the new approach

In other articles, we intend to provide more background and detail for those who are new to the condo hotel scene. But this piece is designed for those who already know the basics, and perhaps even struggled with the limitations of condo hotel structure under the old rules. Thus, we move straight to the key considerations that hampered condo hotels under the old rules, and explore how the “new breed” of condo hotels (structured as securities to take advantage of the latest legal changes) is now positioned to become the dominant approach for this entire niche.

The table below summarizes some of the most significant requirements or features that distinguish the old approach of avoiding security status (and the old SEC rules on private offerings), from the new approach of accepting security status and complying with the new Rule 506(c). The critical requirement for the new approach is that all buyers of condo hotel units must be “accredited investors.” Generally speaking, this means that each purchaser must meet the requirement of either (1) a minimum net worth of $1 million (excluding primary residence), or (2) a minimum income of more than $200,000 per year (or $300,000 for a married couple) for each of the last two years, and reasonably expects the same for the current year.

So here it is in a nutshell, or in this case, a table.

Summary of the big changes wrought by new SEC Rule 506(c) and how it will revolutionize condo hotels

<table>
<thead>
<tr>
<th>Requirement or Feature</th>
<th>Old condo hotel approach: Avoiding “security” status</th>
<th>Revived condo hotel approach: Embracing “security” status</th>
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<tbody>
<tr>
<td>1. Public solicitation or advertising to promote the condo hotel</td>
<td>Prohibited if condo hotel is a “security” but allowed if security status is avoided. However, if the developer inadvertently falls over any of the strict prohibitions in avoiding security status, the offering then becomes a security and the public solicitation made impossible any colorable claim of a private offering.</td>
<td>Allowed. The new rule permits a public solicitation to investors even for a private offering under 506(c) as long as all the ultimate buyers are “accredited investors” meeting minimum net worth and income standards. The requirement of a prior relationship with each potential customers is eliminated.</td>
</tr>
<tr>
<td>2. Selling condos based on investment merit</td>
<td>Prohibited. Cannot emphasize economic, profit or tax benefits of the investment.</td>
<td>Allowed. Can provide full and accurate information.</td>
</tr>
</tbody>
</table>
3. Promote hotel brand and rental program  
   **Prohibited.** Cannot give any information prior to purchase of condo hotel, even on availability or terms of the rental program, except to say: “Ownership may include the opportunity to place your home in a rental arrangement.”  
   **Allowed.** Can provide full details of rental program, copies of relevant agreements and contract terms.

4. Provide relevant financial information about investment (such as comparable hotel performance and real estate values, projections of cash flow and expenses of condo association)  
   **Prohibited.** All this highly relevant information is prohibited. Best answer was, “Because of legal regulations, we are prevented from providing this information.”  
   **Allowed.** Full and fair disclosure of all appropriate information is permitted, including projections.

5. Require condo buyers to participate in hotel rental program  
   **Prohibited.** Cannot provide any terms about rental program until after sale of condo, and then cannot require any rental program participation. Participation in the rental program must be completely voluntary.  
   **Allowed.** Sale of each condo unit can be conditioned on contemporaneous execution of mandatory rental program agreement, maintenance agreement, and related documents.

6. Limit buyer’s rental of condo to program offered by hotel and operator’s front desk  
   **Prohibited.** Cannot impose any substantial restriction on buyer’s use or rental of condo unit. Presented serious issues of multiple rental agents, security, access, maintenance, and the like.  
   **Allowed.** Seller can impose any reasonable contractual conditions to create harmonious condo hotel regime.

7. Limit buyer’s use of condo  
   **Prohibited.** Seller cannot impose restrictions on owner use. Certain use restrictions mandated by municipalities or local government can be passed through to the buyers, at some risk.  
   **Allowed.** No limitation on use restrictions as part of sale or rental program (e.g. owner will not use condo for more than 180 days in any calendar year).

8. Require buyer to rent condo when not in use  
   **Prohibited.** As with the preceding item, developers generally accepted the risk that they could pass through government-mandated requirements that buyers rent their condos, but this was somewhat problematic.  
   **Allowed.**

9. Pooling of income and expenses for owners  
   **Prohibited.** Each owner’s income and expenses must be accounted for separately, and must address issues of rotation so all owners get fair share of income.  
   **Allowed.**
Use single sales force for selling real estate and rental participation program

Prohibited. Under the Intrawest no action letter, the rental program cannot be discussed until after the buyer has purchased the unit, and then the rental program must be handled by a completely separate team of professionals from those who handle real estate sales.

Allowed.

11. Licensing

Real estate broker. As long as the condo hotel is not a security, no securities broker licenses are required.

Real estate broker and securities broker required. Best to find dual licensed sales force.

12. Operator considerations

Many operators have shied away from branding or managing condo hotels because the limitations imposed on avoiding security status present operational issues (such as guaranteeing adequate room inventory and consistency of hotel product).

Many operators will find the new structure satisfies virtually all of their concerns with the condo hotel approach. Branding a new breed condo hotel is similar to branding a hotel owned by a REIT or other investment vehicle — there is no impact on hotel operations.

13. Securities liabilities

Some felt that avoiding securities status avoided securities liabilities. The highly technical and strict requirement of achieving this status may impose greater liability for inadvertent failures, and create a false sense of comfort. Unhappy investors typically sue and claim the offering did involve the sale of a security and failed to have any exemption (such as Rule 506).

Well-structured and documented securities offering may offer less legal exposure to all concerned than the alternative.

Other condo hotel resources

You can access the full library of Condo Hotel materials on Hotel Law Blog by going to the home page, selecting the tab at the top that says “HOTEL LAW TOPICS”, and then clicking on “Condo Hotels” in the drop down menu . . . or by clicking here.

Below is a partial listing of articles by JMBM’s Condo Hotel Lawyers:

- Condo hotels: Don’t forget the secret sauce!
- Condo Hotel Lawyer: What is a Condo Hotel?
- The “new breed” of condo hotels — Key to financing new hotel development? Selling condo hotels as “securities” under new SEC Rule 506(c) . . .
- Using condo hotels for financing new hotel development: Traditional condo hotel structures as “non-securities”
- Condo Hotel fundamentals — 5 Keys to Success!
- Condo Hotels’ enduring legacy: hotel-enhanced mixed-use
- Hospitality Lawyer: The 5 biggest misconceptions about Condo Hotels
- Condo Hotel Lawyer: Why does the SEC care about condo hotels?
- Condo Hotel Lawyer: Standards must be “built in”
- Condo Hotel Lawyer: Not so fast! Locking down the condo hotel structure
- Condo Hotel Lawyer — What is fanning the condo hotel wild fire in Latin America, the Caribbean, Europe, China, India and the Middle East?
- Condo Hotel Lawyer — Las Vegas Report: What drives successful sellouts today?
- Condo Hotel Lawyer — What in the world is going on with condo hotels now?
- Hospitality Lawyer — Trump’s luxury residential mixed-use project in Hawaii sells out in 8 hours. New sales record claimed.

This is Jim Butler, author of www.HotelLawBlog.com and hotel lawyer, signing off. We’ve done more than $87 billion of hotel transactions and have developed innovative solutions to unlock value from hotels. Who’s your hotel lawyer?

Our Perspective. We represent hotel owners, developers and investors. We have helped our clients find business and legal solutions for more than $87 billion of hotel transactions, involving more than 3,900 properties all over the world, including more than 100 condo hotels and hotel condos. For more information, please contact Jim Butler at jbutler@jmbm.com or +1 (310) 201-3526.

Jim Butler is a founding partner of JMBM, and Chairman of its Global Hospitality Group® and Chinese Investment Group™. Jim is one of the top hospitality attorneys in the world. GOOGLE "hotel lawyer" and you will see why. Jim and his team are more than “just” great hotel lawyers. They are also hospitality consultants and business advisors. They are deal makers. They can help find the right operator or capital provider. They know who to call and how to reach them.