Hotel Lawyer with good news! A new federal court decision upholds condo hotel structure. No “securities” involved as structured. Disgruntled condo hotel unit purchaser lawsuit dismissed.

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Hotel Lawyer with good news for well-structured condo hotel deals. With the experience gained as legal and business advisors on more than 100 condo hotel and hotel condo projects, we have said for many years that this type of project has earned an enduring place in the landscape of hotel and real estate development. We still believe that.

The main issues of successful hotel mixed-use development are managing consumer expectations, fulfilling those expectations, and creating a viable mixed-use regime structure. In the case of condo hotels, a viable structure must work from an operational standpoint, be economically sustainable, and avoid triggering violations of Federal and State securities laws.

In a recent lawsuit, involving the Hard Rock Hotel San Diego, a federal district court in California ruled against the condo hotel buyers, finding that no securities laws were violated — the plaintiffs did not allege facts that would cause the condo hotel units to constitute “securities.” We see the case as affirming the effectiveness in defeating plaintiffs’ claims of two structural elements we have encouraged all our clients to use.

My partner, Catherine Holmes, who structures most of our condo hotel regimes, talks about these factors and the case below. Catherine advises clients in the specific business and legal aspects of condo hotel regime structuring and documentation, including securities compliance matters, documentation and training. In her article below, she talks about the case and what it means for us in the condo hotel world. It is good news!

Condo Hotel Wars – Developer, Banks and Broker Win Latest Battle
by
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Developers, banks and real estate brokers involved in condo hotel sales have been the targets of numerous class action lawsuits brought by condo hotel buyers in the years following the financial meltdown of 2008.

As we and other condo hotel experts predicted, the big guns being wielded by the plaintiffs are claims that the sale of condo hotels violated federal and state securities laws.

In the latest skirmish fought in the condo hotel wars, Salameh et al. v. Tarsadia Hotels, et al., involving the Hard Rock Hotel San Diego (HRHSD), a federal district court in California ruled on March 29, 2011, against the condo hotel buyers, finding that they did not allege facts that would cause the condo hotel units in the HRHSD to constitute securities.
For condo hotel developers, bankers and brokers, the case affirms some of the guidelines we have recommended to establish defenses against claims by condo hotel unit buyers based on securities law violations.

**Background.** The HRHSD is a 420 unit hotel condominium sold in 2006 through 2008. In December 2009, the plaintiffs filed their original complaint seeking class action status against seven bank defendants who provided financing either to the project or to the unit buyers, Playground Destination Properties, as the broker of the units, and Tarsadia Hotels and its affiliates, as the developer of the project. A few months later, the plaintiffs filed a first amended complaint, which was dismissed by the court in July 2010. The plaintiffs filed a second amended complaint in September 2010.

The second amended complaint alleged federal and state securities law violations based on the claim that the restrictions imposed on unit purchasers with respect to the maintenance and use of the units created a security that could only be sold in accordance with federal and state securities laws. Based on those allegations, the plaintiffs sought to rescind their purchase of units and receive a return of 100% of their original purchase price, plus other damages.

**Plaintiffs Arguments.** The plaintiffs based their securities claims on the theory that once they purchased their units at HRHSD, they had no control over the rental management of their units. Even though the rental program was voluntary, they claimed that for all practical purposes, it was in fact mandatory. In support of their position, the plaintiffs argued that they were restricted by city zoning ordinance from staying in their units for more than 28 days per calendar year, and they were required to pay for the daily management, operation and marketing of the units as a hotel on the days that they were not allowed to personally use their units. As a result, the plaintiffs claimed that the economic reality of the project was that the units were required to be managed as part of a common enterprise under the rental management contract.

The plaintiffs relied largely on a 1989 case, Hocking v. Dubois, in which buyers in a condominium project in Hawaii were offered a voluntary rental pooling agreement, where all of the participants would receive a portion of the profits of rental of the units.

**Court Findings.** The court concluded that the circumstances in HRHSD differed significantly in two important respects from the condominium units sold in Hocking, and that those differences meant that the condo hotel units in HRHSD were not sold as securities.

First, the court found that there was a significant gap between the date of execution of purchase contracts for units, on the one hand, and the execution of rental management agreements, on the other hand. In HRHSD, the rental management agreement was not offered until at least 8 months after the purchasers signed purchase contracts. By contrast, in Hocking, a rental management agreement was offered just 6 days from the date of signing a purchase agreement, and a rental pooling agreement was offered less than 2 weeks after signing the purchase agreement. So, the court reasoned, the purchase contract and rental management contract were not offered as part of a single package, and therefore were not part of a single investment contract as the plaintiffs alleged.

Second, the court found that it was clear that the units in HRHSD were not marketed as investments, because the purchase contracts specifically required the plaintiffs to represent that they were not purchasing the units for investment purposes and they were not relying on any external representations regarding the rental value of the units. Here, the court found support for its findings in two other cases, Garcia v. Santa Maria Resort, Inc., a 2007 Florida federal district case, and Demarco v. LaPay, a 2009 Utah case, where the courts held that because of the plain language in the contracts indicating that the buyer was not relying on any representations of the seller concerning the investment value of the units.
property or the possibility of profit from rental.

**Lessons Learned.** The court’s ruling in Salameh et al. vs. Tarsadia Hotels, et al. points out the importance of two elements in any condo hotel sales program:

1. **When the Rental Management Contract is Offered** – the longer the time between the signing of a purchase contract and the offering of a rental management contract, the harder it is for condo unit purchasers to claim that the condo units were offered as securities; and

2. **Contract Disclaimers Are Important** – the more disclaimers that are made in a purchase contract that the units are not being offered for investment purposes, and that buyers are not relying on any representations regarding the rental value of the units, the harder it is for condo unit purchasers to claim that they did buy units for investment and in reliance upon the rental value of their units.

**Unanswered Questions.** What would have happened if the rental management contract in HRHSD had been offered at the same time as the purchase contract? Could other elements have been shown that, together with the disclaimers in the purchase contract, would have caused the court to reach the same ruling? The court did not discuss the other elements that the SEC has said are crucial to determining whether a condo hotel is a security, although it did mention two SEC no-action letters in passing, Marco Polo Hotel, Inc. (1987) and Intrawest Corp. (2002). To what extent might the other elements in those no-action letters influence the court’s ruling? There are still many unanswered questions that we hope will be addressed in future decisions. One thing we know for certain is that the latest battle will not be the end of the condo hotel wars.

**The Future of Hotel Condominiums.** Even though we expect that the condo hotel wars will continue as a by-product of the 2008 financial crisis, we believe that hotel condominiums and hotel/residential mixed use projects will be a viable model for future hotel development. Although new hotel development of any kind in the U.S. has been dormant, outside the U.S., the hotel condominium or mixed use hotel/residential development model is being actively used in Asia, Latin America and the Caribbean, particularly for luxury resort developments. A careful design of the operating structure and the sales guidelines can greatly enhance the chances of success of these types of projects. We have advised developers and operators of over 100 hotel condominium and mixed use projects in the U.S. and around the world, in the course of which we have seen projects that have succeeded, and others that have failed. Mitigating the risks of lawsuits by implementing guidelines to comply with U.S. securities laws (even for condo hotel projects located outside the U.S. if they are marketed inside the U.S.), is an important element of a successful hotel condominium project.

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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 help investors be successful in bidding for hotel acquisitions, and helping investors and lenders to unlock value from troubled hotel transactions. Who’s your hotel lawyer?

Our Perspective. We represent hotel lenders, owners 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. For more information, please contact Jim Butler at jbutler@jmbm.com or 310.201.3526.

Jim Butler is a founding partner of JMBM and Chairman of its Global Hospitality Group®. Jim is one of the top hospitality attorneys in the world. GOOGLE “hotel lawyer” and you will see why.

JMBM’s troubled asset team has handled more than 1,000 receiverships and many complex insolvency issues. But Jim and his team are more than “just” great hotel lawyers. They are also hospitality consultants and business advisors. For example, they have developed some unique proprietary approaches to unlock value in underwater hotels that can benefit lenders, borrowers and investors. (GOOGLE “JMBM SAVE program”.)

Whether it is a troubled investment or new transaction, JMBM’s Global Hospitality Group® creates legal and business solutions for hotel owners and lenders. They are deal makers. They can help find the right operator or capital provider. They know who to call and how to reach them.