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Condo-hotels: stuck between a Hard Rock and the SEC rulings

Condo-hotels, which flourished before the real estate meltdown, are facing an uncertain future, even if the economy fully recovers. The ultimate success, or failure, of such projects going forward will depend not only on whether the condo units can be sold and rented, but also on whether the projects are viewed as securities by the U.S. Securities and Exchange Commission.

Condo-hotels have succeeded in several periods of real estate exuberance – in the early 1970s, mid-'80s and, most recently, in the mid-2000s – when the purchase of second-home resort real estate seemed easily accessible. For those developers who sold out early, the projects worked. Not so for those projects that relied on consumer sales to bolster hotel projects that could not have otherwise been underwritten as commercially owned hotels.

Aside from economic challenges, sales of condo-hotels also raise the specter of compliance with state and federal securities laws. The U.S. Supreme Court in *SEC v. W.J. Howry Co.* (1946) provided the test for determining whether a transaction qualified as an investment contract and hence, a security. The court defined an investment contract as any "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or third party." In basic terms, real estate sales contracts for condo-hotel units may become investment contracts if the real estate purchaser expected profits based solely on the efforts of the hotel operation. In a sense, the unit owner is buying into the commercial hotel enterprise with the share of equity ownership reflected in the condominium unit.

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Developers have looked to a 1973 SEC Public Release (Release No. 33-5347: "Offer and Sales of Condominiums or Units in a Real Estate Development") and numerous SEC no-action letters surrounding the 1973 Release as a safe harbor against treatment of a real estate contract as an investment contract. There the SEC focused on the troubling combination of a real estate sales contract (for the unit) and the rental management agreement (for the expectation of profit). In the 1973 Release and later no-action letters, the SEC encouraged the separation of the two agreements as far as possible.

One of the clearest descriptions of how to conduct a condo unit sale without stepping over the *W.J. Howry* line involved Intrawest Corp., a developer with a prior history of selling condo-hotels in Canada without pesky U.S. securities laws. With Intrawest's expansion into U.S. ski resorts – particularly Copper Mountain – the company sought guidance on how to sell condo-hotels in compliance with U.S. securities laws. In 2002, the SEC issued the Intrawest no-action letter (*Intrawest Corporation*, Nov. 8, 2002) that focused on the sales process (such as separate offices for unit sales personnel and rental managers) and disclaimers (such as a buyer-signed acknowledgement of "no expectation of profit"), rather than the underlying structure of the product being offered. Under this model, Intrawest and others have sold resort rental units successfully and without SEC complaint throughout the recent boom.

But recent activities in the California case of *Salameh et al. v. Tarsadia Hotels*, et al., threaten this long-standing model. Purchasers of condo-hotel units at the Hard Rock Hotel San Diego, seeking to rescind their purchases, filed an action in 2009 against the developers, brokers, and certain lenders to the project. In the condo unit sales contracts, purchasers expressly disclaimed any expectation of profit and affirmed they were not relying on any representation of investment value or rental revenue. By all indications, the sales teams followed the Intrawest no-action letter guidelines.

In 2011, the U.S. District Court for the Southern District of California dismissed the plaintiffs' complaint and relied heavily on the Intrawest no-action letter in concluding that the sales process matched the SEC's prior guidance, hence no security.

But the unit-purchaser plaintiffs appealed to the 9th Circuit last summer. The SEC filed its amicus brief taking a game-changing position, effectively disregarding its past no-action letters, particularly the Intrawest letter. In its amicus brief, the SEC argues the overall product structure should be analyzed, not just the meticulously followed sales process. The commission also argues that written disclaimers should be given no weight in the face of practical reality. The SEC's message seems to attack the entire condo-hotel structure, not solely the Hard Rock, narrowly construing or ignoring various factors that the SEC previously relied upon in granting no-action letters.

In response, the Real Estate Roundtable and the National Association of Realtors also have filed amicus briefs, arguing that developers and sales teams have relied on the Intrawest guidelines in creating a uniform product to match that guidance, which the SEC now threatens nationally.

Even if the 9th Circuit upholds the District Court dismissal of the case, the SEC has made it clear to the industry that Intrawest and other past guidance cannot be relied upon. The underlying condo-hotel structure must avoid characterization as a security, based on a totality of the circumstances test, which is increasingly difficult to divine. It seems, for this exuberant round at least, the condo-hotel party is over.▲