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Condo Hotels As Securities: Has The Litigation Boom Begun


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During the past couple of years, it's been hard to miss articles in the press concerning one or more aspects of the proliferation of the "condo hotel." Those articles have generally dealt with potential issues that might arise from the new mixed property uses, the soundness and reasons for investments in condo hotels, and legal issues relating to the purchase, sale, and management of the condo hotel. One potential issue that was the subject of many articles concerning the condo hotel boom - - including an article by this author - - was whether dissatisfied condo-hotel unit owners would seek to assert claims against developers alleging that the sale of a condo hotel unit constitutes the sale of a security, thus giving rise to the right to rescind a condo unit purchase contract and seek damages, under federal and state securities laws.

Thus it is not surprising that a review of recent press reports concerning failing condo hotel projects indicates that disgruntled condo hotel owners and investors are, indeed, relying on federal and state securities laws to attempt to rescind their purchase agreements and seek damages. As such, and because the issue of whether the sale of a condo hotel unit constitutes the sale of a security has been thus far unresolved by any court, the outcomes of these first cases will be watched closely by, among others, attorneys, purchasers of condo hotels, developers, and management companies involved in condo hotels.

For example, the Wall Street Journal recently reported about a lawsuit filed in federal district court in Florida by the owners of condo hotel units at the Clearwater Cay Clubs Resort (the “Clearwater Resort”) in Clearwater, Florida. In that lawsuit, the plaintiffs allege that the Clearwater Resorts' vendors and developers violated both federal and Florida state securities laws by fraudulently inducing them to invest in condo hotel units. Specifically, the plaintiffs allege that defendants promised them: (i) “substantial profits” from the investments through guaranteed income from a pool of short-term rental units; and (ii) capital appreciation due to a large scale conversion/development. Based on the allegation that the sale of a condo hotel unit constitutes a sale of a security, plaintiffs allege that the units were required to be, but were not, registered with the Securities and Exchange Commission (“SEC”), and seek damages.

A similar lawsuit was filed by condo hotel unit purchasers at the Resort at Singer Island (the "Singer Island Resort") in Palm Beach, Florida. The Singer Island Resort plaintiffs allege that defendants violated federal securities law by selling the condo hotel units as investments without registering the units with the SEC. As a remedy, the plaintiffs are seeking monetary damages and the rescission of their purchase agreements.

Finally, the New York Attorney General’s Office has joined the condo hotel as securities fray, recently ordering The Related Group to refund pre-construction deposits to buyers who were marketed and sold Florida condo hotel units in New York State. The directive was issued under New York State securities law.

It is still difficult to predict whether the recent lawsuits alleging federal and state securities laws violations arising from the sale of condo hotels will prove to be successful. The difficulty in answering this question is, among other things, that courts have yet to decide whether a condo hotel sale constitutes the sale of a security.

In Securities and Exchange Commission v. W.J. Howey Co., 328 U.S. 293, 298 (1946), the United States Supreme Court found that when, applying "economic realities," a sales contract is "a 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 a third party," that contract is an "investment contract" and, therefore, a security. A condo hotel purchaser typically has the option of renting his or her unit to hotel guests, which would likely be handled through a reservation system or a rental program. Since the condo hotel unit is associated with a rental program it could potentially be deemed to be security. If deemed to be a security the sale of a condo hotel unit must be registered with the SEC and comply with the SEC's rules and regulations, including its anti-fraud provisions.

In the absence of direct judicial precedent on the issue, commentators have suggested that guidance can be found in a 1973 SEC release and 2002 no action letter. The 1973 SEC release addressed "uncertainty about whether offers of condominiums and other types of similar units may be considered to be securities" ("Condominium Release"). In the Condominium Release, the SEC found that offering securities in the form of an investment contract would arise if the condominiums were: (1) sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party from rental of the units, (2) include participation in a rental pool arrangement, and (3) require the purchaser must hold his unit available for rental for any part of the year, must use an exclusive rental agent or is otherwise materially restricted in his occupancy or rental of his unit. In 2002, the SEC issued a no action to letter Intrawest Corporation, concerning the "the offer and sale of condominium units . . . coupled with an offer or agreement to perform or arrange certain rental or other services for the purchaser." The SEC stated that Intrawest's sales and rental model did not create a security because the promotion and sale of units did not emphasize any economic benefit to the purchaser derived from managerial efforts or rentals. Intrawest had represented that: (1) under no circumstances would purchasers be led to believe that they would profit from unit ownership except for property value appreciation; (2) the rental management company would only provide information in response to specific questions; (3) Intrawest's rental management program would be completely separate from the Intrawest sales program, (4) sales representatives would not receive additional compensation for unit sales tied to rental management agreements, and (5) Intrawest would not discuss the terms of any rental management agreements until a purchase and sale agreement had been executed.

If the SEC's Condominium Release and no action letter prove to be reliable guides to the law, the success of the recent lawsuits alleging violations of securities laws will depend on whether the promotion and sale of the condo hotel units emphasized any economic benefit to the purchaser derived from managerial rental efforts. If buyers, as alleged in the Clearwater Resort and Singer Island Resort lawsuits, were led to believe that the purchase of the condo hotel unit would generate guaranteed income from rental arrangements, courts may very well find that federal securities laws apply, and were violated. If securities laws apply, condo hotel developers and brokers could face serious criminal and civil liability repercussions. Moreover, it is possible that states' Attorneys General could follow the lead of the New York State Attorney General's Office and scrutinize condo hotel projects under state securities laws.

With the recent down turn in the the real estate market and investors failing to achieve their expected investment returns, the recent flurry of lawsuits alleging claims for violations of federal and state securities laws may only be the beginning of a new type of condo hotel boom.

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