

Guest Column: Condominium Hotels—A New Way to Solve the Rental Program Problem

Read More: [Paul Berkowitz](#) · [Gary Saul](#) · [Greenberg Traurig](#)



Paul Berkowitz



Gary Saul

By Paul Berkowitz and Gary Saul

Keeping rental programs from being treated as an unregistered security has historically posed a serious problem for condo hotels. Now, there is a solution, thanks to Rule 506(c) as adopted by the **Securities and Exchange Commission** under the JOBS Act.

Until now, to comply with the rules, a rental program could not be discussed at all by the real estate sales people nor could the details of the program be disclosed until the purchase decisions had been made. Advice as to when that information could be disclosed varied from the expiration of the real estate purchase rescission periods to months later (see the [Tarsadia decision](#)^[1]). No pooling of revenues was permitted, and restrictions on use could not cross a fine line.

Even more significantly, participation in any rental program had to be voluntary. This led to numerous problems, particularly in dealing with competing rental management programs. Issues include: Do subtle differences in availability of services or fees result in a “sponsored” program that is not really voluntary? How do you charge for housekeeping services? How do you tell a guest renting through another program that the malfunctioning television is not your problem without damaging the flag’s reputation? Is the front desk available to all hotel guests? Can the outside agent use the hotel’s logos and trademarks in its advertising? Without a doubt, developers and hotel operators do not want to face these questions on a daily basis.

Enter Rule 506(c)

Here’s how Rule 506(c) offers a solution. Prior to Rule 506(c), if the rental program constituted a “security,” the applicable rules prohibiting “general solicitations” and “general advertising” precluded the offering from qualifying as a private placement. The new rule, however, allows issuers of securities to engage in these activities in connection with unregistered securities offerings as long as certain conditions are met. As a result, developers may acknowledge that the rental program is a security and disclose, prior to sales of the units, the details of the program including splits, use restrictions and projections. They also may pool revenues and most important, the program may now be mandatory.

The Requirements

Sales of securities under Rule 506(c) may only be made to persons who the issuers have taken reasonable steps to “verify” are “accredited investors.” Accredited investors are generally defined as those with certain levels of income or net worth.

The SEC has adopted an objective, principles-based approach to verification that allows issuers to apply sliding-scale diligence standards to their verification procedures, requiring less verification where the circumstances make it more likely that the purchasers are in fact accredited investors. The SEC has also provided certain nonexclusive safe harbors that provide that issuers of securities will be deemed to satisfy the verification requirements if they take the following steps:

- Obtain copies of Internal Revenue Service forms (e.g., Form W-2, 1099, 1040) that indicate the purchaser's income for the two most recent years and a representation from the purchasers that they expect to reach the necessary income levels to qualify in the current year as accredited investors;
- Obtain copies of bank statements, brokerage statements and other statements indicating the value of such persons' assets (or a portion thereof), consumer reports from consumer reporting agencies confirming the purchasers' liabilities, and representation from purchasers that they have disclosed all liabilities necessary to make determinations of their worth; or
- Obtain written confirmation from registered broker-dealers, registered investment advisers, licensed attorneys, or licensed certified public accountants indicating that reasonable steps have been taken to verify the purchasers' status as accredited investors.

For foreign buyers reluctant to disclose their net worth or income, the principles-based approach would allow issuers to take into account other factors, including for example the purchase of condominium hotel units with high purchase prices without debt financing.

Disqualification of “Bad Actors”

The SEC also adopted new “bad actor” rules that will prohibit issuers from relying on Rule 506 if the issuers, their officers or directors, any owners of 20 percent or more of the issuers' outstanding voting securities, or certain other persons affiliated with the issuers or involved in the offerings, have been subject to any convictions or restraining orders related to the purchase or sale of securities.

The Offering Process

Potential purchasers would be provided with offering memorandum describing, among other things, the nature and amount of “securities” being sold, the management company and the developer, the material terms of the rental program, the potential income opportunity represented by the rental program (including projections and other forward-looking information) and the material risks involved in making an investment in the rental program. The offering memorandum would serve a dual purpose: helping satisfy the disclosure requirements under applicable securities laws while

also providing information that investors want prior to making investment decisions. As with any offering of securities, brokers and other representatives of issuers would be prohibited from deviating from the printed offering memorandums when speaking with potential investors.

Although there is no specified minimum level of information to be included in the offering memorandum, the anti-fraud provisions of the federal securities laws require that the offering memorandum not contain any material misstatements or omit any material information.

In short, use of Rule 506(c) solves many of the rental program issues and should be examined as a viable alternative for developers.

*Paul Berkowitz is a shareholder in the corporate and securities practice and **Gary Saul** is a shareholder and co-chair of the Miami real estate practice of international law firm **Greenberg Traurig**.*

[1] Salameh v. Tarsadia, 726 F.3rd 1124 (9th Cir. 2013).