Hotel Business

Avoid ligitation
Structure your condo-hotel project now

By Paul Berkowitz and Gary Saul
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Avoid litigation
Structure your condo-hotel project now—or sue later

A recent federal court case in Florida involving the Fontainebleau Miami Beach is a great example of how simply following the old rules set out by the Securities and Exchange Commission (SEC)—including the November 2002 Intrawest Corporation No Action Letter—can lead to operational challenges with your condo-hotel project.

Let's take the best-case scenario: Approximately 75% of unit owners voluntarily elect to rent their units through a rental management program administered by your organization. The rental management agreement provides that the rental manager has the "sole and exclusive authority and right to rent, operate, manage and administer the unit." The result is supposed to be a relatively stable availability of rooms for rent by hotel operations.

But it doesn't always work that way, as the Fontainebleau litigation indicates. What can happen is that a competing organization contacts the owners in your program and proposes to act as their rental agent. Even more troubling, this company advertises the units on its website and other third-party sites using the brand name of your hotel. Vouchers are offered on third-party websites that consumers attempt to redeem directly from the hotel. Consumers get frustrated when the hotel will not assist with these bookings and the flag does not recognize the third-party vouchers, all of which hurt your hotel's reputation. That's exactly what happened, according to the plaintiffs in the Fontainebleau Miami Beach trademark dispute, which settled last month.

So, what does a hotel owner do? Hire an attorney to write threatening letters and, ultimately, file suit against the competing rental agent claiming trademark infringement through the advertising, and tortious interference with business relationships as a result of the contacts to the owners participating in the rental program? The defendants can be expected to respond by denying the claims and setting out their legal theories. It is doubtful that this is a particularly attractive scenario for either the developer or the brand.

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Others have responded to the efforts of third-party rental agents in different ways. Condominium declarations have included provisions requiring the completion of an application and paying fees to act as a rental agent; proof of licenses and insurance; the presence of a full-time representative to meet guests upon arrival; cash escrows; and arrangements for daily housekeeping. These and other conditions provide opportunities for legal challenges but, even if the challenges are not successful, the result is increased acrimony at the property.

There is a solution: Treat the rental program as a security. Although prior rules prohibited "general solicitation" and "general advertising" in an offering not registered with the SEC, Rule 506(c)—as adopted by the SEC under the JOBS Act—now

Paul Berkowitz
Greenberg Traurig

Gary Saul
Greenberg Traurig

permits such actions resulting in the ability, with appropriate disclosure, to require that all rentals must be managed through the flag. If offering pursuant to this rule, a sponsor may now disclose the details of the rental program, including—most significantly for this analysis—the fact that the program is mandatory, prior to the sale of the unit and signing of a rental-program agreement. In addition, many of the related activities that posed potential securities law risks may now be discussed, such as revenue splits, blackout periods, the operating experience of comparable projects and, even if desired, projections. In fact, a concept previously strictly prohibited, pooling of revenues, is now permitted.

The principal requirement for the use of Rule 506(c) is the "verification" of the fact that investors are "accredited." Although the SEC is currently considering modifying the requirements for an accredited investor, the rules now in effect are relatively familiar: income or net-worth tests. In addition to adopting an objective, principles-based approach to verification allowing users to apply sliding-scale diligence standards to their verification, the SEC has also established nonexclusive safe harbors, including obtaining copies of tax returns, bank statements or written confirmations from third parties to establish the requisite income or net worth. All of these requirements can be met without interfering with the sales process.

In summary, we believe that the use of Rule 506(c), together with well-crafted offering documents, provides an effective solution to these problems and avoids litigation in the future.

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