

Federal Appeals Court Says Sale of Condo Hotel Units Did Not Constitute A Sale of Securities

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September 10, 2013

On August 13, 2013, a federal appeals court affirmed the dismissal of a suit alleging that sales of condo hotel units in a San Diego hotel constituted the improper sale of securities. One of the most significant risks faced by a condo hotel developer is avoiding any action that would cause sales of units to be treated as sales of securities, and this decision provides further guidance to developers in this regard.

Each plaintiff in the case purchased a condo hotel unit in the hotel from the hotel's developer. Several months later, each plaintiff also executed a separate rental management agreement with the hotel's operator.

Contending that they had been defrauded into purchasing an "investment" property, the plaintiffs filed suit alleging, among other things, violations of Federal and California securities laws. The crux of the complaint was that the purchase and sale agreements and the unit rental management agreements, taken together, constituted a single investment contract and were, therefore, a "security" under Federal and California securities laws that required the defendants to make various disclosures prior to plaintiffs' purchase of their units.

In support of their contentions, the plaintiffs alleged that they had no control over their units (even to the point of being required to obtain room keys from time to time from the hotel operator) and expected to profit from their investment only through the efforts of the hotel operator to rent the units. Plaintiffs also alleged that they had no practical choice but to sign the rental management agreement with the hotel operator because local zoning regulations prohibited them from occupying their units more than 28 days per year.

The court rejected plaintiffs' contentions, holding that plaintiffs failed to allege facts sufficient to show that they in fact were sold a security. Specifically, there were no facts showing that the rental management agreement was used as an inducement to the sale of the units. The purchase and sale agreements and the rental management agreements were not offered as a package, nor were plaintiffs told they would be forthcoming at the time the purchase and sale agreements were signed.

Plaintiffs also failed to allege that the defendants ever advised that the rental management agreement would result in investment-like profits. Finally, the court noted the long time gap between the signing of the purchase and sale agreements and the rental management agreements as confirmation that the two transactions were in fact distinct.

This case adds to the body of federal case law indicating when the sale of a condo hotel unit

constitutes the sale of a security for federal law purposes, and should be considered, with other available guidance, by developers engaged in the development and promotion of condo hotel projects.

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