# TIMESHARE AND FRACTIONAL RESORT DEVELOPMENT & SALES

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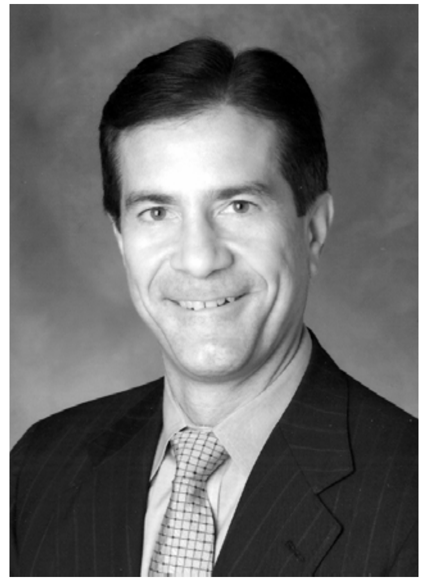

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**Summary:** John Melicharek, Jr., is the Baker & Hostetler LLP Hospitality Industry Team Leader and has been advising clients for over twenty years on business and transactional matters. He maintains a diverse real estate and business practice with a strong emphasis on resorts, hotels and the travel and leisure industry. He regularly counsels clients regarding hotel and resort acquisitions and dispositions, joint ventures, complex financing transactions, raising capital, franchising, leasing, licensing and securities matters.

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Mr. Melicharek is a member of the American, Florida and New Jersey State Bar Associations and is actively involved in the Urban Land Institute – Recreational Development Council and the Organization for Timeshare in Europe. Mr. Melicharek is a member of the Board of Directors of the Orlando-Orange County Convention and Visitors Bureau. He has lectured on such topics as raising capital, loan participations, mixed-use development, acquisition financing, timeshare legal issues, condominium hotels and starting a new business.

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## A. Timeshare Resorts

### 1. Structure

a. Generally, timeshare interests are structured in one of two ways: as timeshare estates or as timeshare licenses. A timeshare estate conveys the right to use vacation accommodations and facilities coupled with an underlying real property interest therein. A timeshare license conveys a similar right to use that is not coupled with any underlying real property interest. Although hybrids exist, most U.S. jurisdictions consider timeshare estates to be real property interests and timeshare licenses to be personal property interests. As will be discussed below, this distinction has major implications for tax, accounting and financing purposes.

b. The purchaser of a timeshare estate receives a deed and obtains all the rights and liabilities associated with owning real property. The purchaser of a timeshare license acquires contractual use rights with the general legal status of a licensee. The timeshare license includes few, if any, of the rights and liabilities associated with owning real property. Instead, the timeshare developer generally retains the title to the real property underlying the timeshare plan; controls the operation, management, improvement, and repair of the resort property and the method of recovery of the costs thereof from the timeshare purchasers through annual assessments; and receives any condemnation awards or insurance proceeds regarding the resort property.

### 2. Real Property Interests

a. One of the first matters a developer must consider in structuring a U.S. timeshare project is the underlying interest in the real property the developer owns or can acquire and subject to a timeshare plan. For example, if the developer wants to sell a deed-based timeshare product it generally is easier to accomplish this goal if the developer has a fee simple ownership interest in the real property that will underlie the timeshare plan, rather than a leasehold interest.

b. The most common approach in the United States is to submit all of the developer’s fee simple title in the property to a timeshare regime. Under this approach, the developer will declare all of its right, title and interest in the real property to a timeshare plan, usually in phases to match sales. When the developer records the timeshare declaration encumbering the property, the developer’s interest is converted to timeshare interests (generally timeshare weeks), and the developer’s interest in the real property, in the nature of unsold timeshare inventory, is phased out as the developer sells that inventory.

c. A developer with a leasehold interest will generally not be able to sell a deed-based timeshare estate to the timeshare purchaser.

d. As with any real estate based product, the developer must have a clear understanding of state and local laws and underlying title matters that could affect the timeshare development. While it may be unusual for local zoning and land use laws specifically to regulate timeshare development (except for jurisdictions such as Florida, California or Colorado where timeshare projects are common), land use laws and zoning regulations setting development limits or restricting transient use of accommodations are not out of the ordinary.

e. Some state timeshare laws also will require that the timeshare interest conveyed to the timeshare purchaser be free and clear of liens or encumbrances or that interest holders in the underlying property execute and record subordination or non-disturbance agreements to protect the timeshare purchasers.

## 3. Timeshare Regimes

a. Once the developer has obtained its interest in the property to be subjected to the timeshare plan and verified that there are no local laws or title issues restricting or prohibiting timeshare development, selection of the proper subdivision vehicle is the next step in the development of a U.S. timeshare project. In this regard, the developer typically has four options: (i) undivided interest ownership; (ii) the condominium form of ownership; (iii) the cooperative form of ownership; or (iv) use of a trust vehicle.

b. An undivided interest structure is created by the recording of a declaration of covenants, conditions and restrictions. In an undivided interest project, the purchaser receives an “undivided interest” in the entire parcel as a tenant-in-common with all other purchasers. Use of the property and the vacation accommodations located on the property is then restricted by the declaration of covenants, conditions and restrictions.

c. A condominium is created by the recording of a declaration of condominium. The declaration of condominium divides the real property into units and common elements. The purchaser of a unit in the condominium receives exclusive ownership of that unit and a percentage share in the common elements related to that unit.

d. In a cooperative, a corporation (usually a non-profit association) owns the accommodations and common areas, and purchasers receive shares in the cooperative corporation and a license or lease to use the accommodations. The cooperative documents then govern the use and occupancy of the property.

e. A trust vehicle operates in a manner similar to a cooperative. The trust owns the real property and improvements and the purchasers are the beneficiaries of the trust, with the trust documents governing the use and occupancy of the property by the purchasers.

4. **Creating the Timeshare Plan**

a. The timeshare plan is the division of the accommodations into periods of time. This is accomplished by subjecting the subdivided real property to a timeshare plan, either through a separately recorded instrument or as part of the underlying declaration of covenants, conditions and restrictions, declaration of condominium, cooperative document or trust instrument.

b. Most jurisdictions in their statutes, define a timeshare plan as any arrangement in which a purchaser receives ownership rights in or the right to use vacation accommodations and facilities, if any, for a period of time of less than a full year, during any given year and which right to use occurs for more than a stated number of years. As stated previously, the two general categories of timeshare interests are timeshare estates and timeshare licenses.

c. As a purely practical matter and as is more customary outside of the United States, most timeshare developers would prefer to sell timeshare licenses instead of timeshare estates. A timeshare license plan allows the developer to retain ownership of the underlying property; avoid owner democracy and control; maintain maximum flexibility over the use, operation and development of the property; develop and sell a less complicated product; avoid certain real estate finance laws; foreclose the timeshare license through non-judicial means if the purchaser defaults on the purchase-money loan; and ultimately receive back the underlying property upon expiration of the timeshare plan.

d. However, various accounting, tax and regulatory reasons, most developers in the United States now develop timeshare estate plans instead of timeshare license plans. In 1977, the Internal Revenue Service issued a private letter ruling [PLR 7803005 (Sept. 30, 1977)] commonly known as the *Windrifter* ruling, which specifically addressed federal tax treatment of timeshare licenses. The Internal Revenue Service now considers the sale of a timeshare license to be a “lease” and not a “sale,” meaning the developer of the timeshare plan must recognize in the year of sale, all of the income from the sale of the timeshare license (subject to limited installment sales reporting) and cannot deduct all of the costs of construction or other costs of sale, including commissions, in that year. Instead, the costs of acquisition, construction and other deductible costs of sales must be amortized over the term of the timeshare plan. Similarly, generally accepted accounting principles may also dictate that such transfers be booked as leases.

e. Consequently, developers may not be able to fully recognize earnings from timeshare license transfers in the year of sale. For purchasers, there is also no second home mortgage interest deduction available for the payment of interest on the purchase of a timeshare license as there may be, under some circumstances, for the purchaser of a timeshare estate. In addition, state sales and use tax laws also have a potential negative impact on timeshare license plans. Since a timeshare license generally is treated as a personal property interest, the sale of timeshare licenses may be subject to sales and use tax with the sales tax due at time of sale on the entire amount of the purchase even if the consumer is paying the purchase price pursuant to a note payable to the developer over time.

f. The developer of a timeshare license plan also must contend with the preference of state regulators for deeded products. For example, Wisconsin actually prohibits the sale of timeshare licenses in that state. Section 707.04(2), *Wis. Stat.* (1997). Florida's timeshare law provides that a purchaser may cancel the timeshare license purchase contract at *any time* the accommodations and facilities are no longer available as originally described. Section 721.06(1 )(g), *Fla. Stat.* (1998 Supp.). Many state timeshare laws require that purchasers of timeshare licenses be protected through the execution and recordation of some sort of subordination or non-disturbance instrument.

g. Since a timeshare license is a personal property interest, financing must be completed under applicable installment sales laws, which can be restrictive, complicated and costly. For example, in Florida the amount of interest that may be charged on an installment sales contract is capped at 12%, a significant limitation in the timeshare industry. Section 520.34(b)(a), *Fla. Stat.* (1998 Supp.). It is also the opinion of many timeshare salespeople that the sale of a timeshare license is more difficult to achieve than the sale of a timeshare estate. They believe that U.S. consumers desire and expect the benefits of deeded ownership such as the availability of title insurance, the price of ownership of property, and the ability to pass timeshare interests on to heirs.

5. **The Timeshare Use Plan**

a. Regardless of the underlying legal structure, and whether a purchaser ultimately will receive a timeshare estate or a timeshare license, every timeshare project must have a detailed use plan. The use plan is the rules or covenants that govern and describe how and when respective purchasers may use the timeshare resort's accommodations and facilities. Use plans in the United States vary from the relatively simple to the extraordinarily complex. As a general rule, the simplicity of a timeshare use plan is inversely proportional to its flexibility and costs of creation and administration and directly proportional to its simplicity.

b. For example, a use plan which grants a purchaser the right to occupy the same unit during the same week each year is relatively simple and inexpensive to create, administer and have approved by the state regulators; however, it does not provide the purchaser with any flexibility regarding use of the resort during alternate times of year or intervals of less than seven consecutive days. Use plans which provide more flexibility necessarily are more complex, requiring sophisticated reservation system rules and software to operate and involving more cost from a legal and regulatory standpoint to create and maintain.

c. Most of the early timeshare resorts developed in the United States had simple fixed week/fixed unit use plans such as the one described above. In order to provide the managing entity with more flexibility to perform its maintenance obligations, some developers began offering fixed week/floating unit plans which granted purchasers the right to occupy a particular type of unit (i.e., 1-bedroom, 2-bedroom, etc.) during the same week each year, with the specific unit to be assigned at the time of check-in. Today, to be competitive in the timeshare market and provide purchasers with greater options for using the timeshare product, many developers offer use plans with an array of flexible use features.

d. The most basic of these flexible use features is the "floating week." A floating week plan grants a purchaser the right to reserve one week each year, usually on a first come, first served basis, in competition with other purchasers of similar timeshare interests at the resort. Floating week plans may allow a purchaser to reserve any week during the year, or only weeks which occur during the same designated season in which the purchaser's timeshare interest falls.

e. An even more flexible use feature that currently is being offered by some timeshare developers is the "point system." A point system is a use plan that utilizes "points" as a form of administrative currency for the purpose of assigning relative value to each timeshare interest in a given reservation system. For example, a high season week in a three-bedroom unit may be assigned a value of 10,000 points. Instead of actually using a high season week in a three-bedroom unit, the owner of this timeshare interest may instead use his points to reserve a low season week in a two-bedroom unit worth 6,000 points and another low season week in a one-bedroom unit worth 4,000 points. Likewise, the owner of a low season week in a two-bedroom unit may be able to use his allotment of points to reserve three days of high season use in the same two-bedroom unit or possibly five days of high season use in a one- bedroom unit.

f. While the different types of use plans described above constitute an overview of the basic options available to a timeshare developer, there are numerous variations on how they may be implemented. In designing the use plan for a particular project, the developer must consider how much flexibility is truly necessary and weigh it against the prospective costs and complexities associated with creating and administering the reservation system. The developer also must consider how the complexity of the product may affect the sales process. If the product is too complicated, sales people are faced with either expanding an already lengthy sales process with potential consumer backlash or leaving out a discussion of critical aspects of the use plan with potential consumer dissatisfaction arising when the consumer first encounters unexpected procedures or rules.

6. **Vacation Clubs**

a. In recent years, developers of timeshare projects have not only concerned themselves with the development of the physical timeshare product and the use plan at one site, but also have focused on a long-term strategy for entering into the U.S. timeshare industry that takes into account the potential development of more than one project. Multi-site timeshare plans, also known as vacation clubs, were created to address the need to develop this long-term strategy. Vacation clubs also serve as the means by which the developer brings consistency and quality to their customers' exchange experiences at other timeshare resorts, captures the opportunity to sell their customers more than one timeshare interest, and develops a distribution mechanism for marketing projects at off-site locations. Major U.S. developers such as Marriott, Hyatt, Hilton, Starwood, Wyndham and Disney all operate vacation clubs

b. Legally, a multi-site timeshare plan is a timeshare plan in which several timeshare projects are linked together through a mandatory reservation system. A mandatory reservation system is one in which the consumer either does not have a priority right to reserve accommodations at a particular resort and all accommodations in the system are pooled and available on a first come, first served basis, or the consumer's failure to reserve at his home resort by a prescribed period of time will result in those unreserved accommodation rights dumping into a pool and becoming available to owners from all resorts on a first come, first served basis.

c. A developer should not develop a vacation club in the United States without fully understanding the costs and complexities involved. Given the complexity involved in managing and coordinating the reservation requests of a vacation club, the developer either will need to expend a significant amount of funds to purchase the hardware and software necessary to run the system or engage one of the few available service providers to run the system for the vacation club. In addition, a structure that links the various club resorts meeting legal and practical requirements and rules and procedures to manage owner use of the vacation club and club resorts must be developed. As with use plans, the level of complexity involved in meeting these objectives will affect costs and the sales process.

## B. Fractional Projects

1. Timeshares offer purchasers prepaid use rights in vacation accommodations and amenities for at least a minimum number of years that varies from state to state, which use rights may or may not be accompanied by an interest in real estate or a proprietary, beneficial or membership interest in a trust, corporation or other business entity.

2. Fractionals are almost always structured as common ownership real estate regimes, with purchasers receiving undivided fractional or percentage ownership of a unit or accommodation within the regime or in the regime itself.

3. Fractional plans tend to offer purchasers the use of at least four weeks to up to twelve weeks per year.

4. Fractionals traditionally tend to be higher-priced products designed for a great deal more purchaser use along the lines of a second home, and for individual or family annual incomes in excess of $100,000.

5. A properly informed timeshare purchaser buys his or her interest with the expectation of being able to use and enjoy it, but without any expectation of investment, appreciation or significant product liquidity through rental or resale. A fractional purchaser often approaches the product as an investment in a real estate asset with the ability to use the accommodations from time to time.

6. Fractional developers expect to be able to sell with a much lower marketing cost than timeshare developers and therefore usually put much more money into the cost of land, construction of improvements and amenities, and unit furnishings and case goods as a percentage of purchase price, therefore creating a more luxurious product.

7. Timeshare developers as a rule rely heavily on exchange programs to maximize both flexibility and perceived product value for their purchaser. Fractional developers have mixed opinions about the importance of exchange, although most agree that an exchange opportunity with other truly equivalent high-end products is desirable to some extent.

8. Timeshare developers usually provide or originate financing for their purchasers and then factor these consumer receivables to generate the day-of-sale cash that they need to meet current development, marketing and sales, and overhead expenses. Fractional developers generally establish a relationship with one or more third-party lenders who, in turn, originate their purchase-money financing.

9. It is currently the general rule that fractional programs are required to comply with the same state laws and regulations as are timeshare programs.

10. Certain fractional plans have obtained informal rulings from certain jurisdictions that some or all of the timeshare regulations of those jurisdictions are inapplicable to those plans. In come cases, this is the result of a calculation of the number of use periods that are created by the fractional program and a conclusion, sometimes somewhat logically strained, that the total number of use periods falls below that jurisdiction's minimum regulatory threshold. In other cases, the skill or political acumen of counsel has achieved a similar result.

## C. Rental Program and Pools – Implications on Real Estate Interests as "Securities"

1. Under certain circumstances the sale of a real estate interest coupled together with a rental program, can be held to be a sale of a security under both federal and state law. If such sale does, in fact, constitute the sale of a security, such sale must be either registered with the federal government and/or applicable state agencies, or an exemption must exist with respect to such registration or to the underlying transaction. Otherwise, without such registration or exemption, the seller of such "security" will be liable for both substantial criminal and civil penalties under federal and state law.

2. In order to determine whether the sale of a real estate interest, coupled together with the offer of a rental program, would constitute the sale of a security under federal and state law, it is necessary to focus on the definition of a security. The definition of "security" pursuant to both federal and state law typically includes the phrase "investment contract," which has become the "catch-all" clause of such definition. Both federal and state regulators have utilized the phrase "investment contract" in classifying a "non-traditional" transaction, such as a sale of an interest in real estate coupled together with the offer of a rental program, to determine whether or not such transaction constitutes the sale of a security.

a. *Howey Test* – The term "Investment Contract" has been considered in numerous federal and state cases over the years. The federal definition of an investment contract is typically interpreted pursuant to the test formulated by the Supreme Court in <u>Securities & Exchange Commission v. W.J. Howey Co.,</u> 328 U.S. 293 (1946). The <u>Howey</u> case states that:

> The definition of an investment 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.

Thus, the definition of an investment contract can be divided into four elements: (i) an investment of money, (ii) in a common enterprise, (iii) produced by the efforts of others, (iv) with an expectation of profit.

b. *Hawaii Market Center Test* – Many states also follow the definition set forth in the Howey case. However, a significant minority of states follow a somewhat different test which was set forth in Commissioner of Securities v. Hawaii Market Center, Inc., 485 P. 2d 105 (1971). The court in Hawaii Market Center held that an investment contract is created whenever: (i) an offeree furnishes initial value to an offeror; (ii) a portion of this initial value is subject to the risk of the enterprise; (iii) the furnishing of the initial value is induced b y the offeror's promises or representations which give rise to a reasonable understanding that valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise; and (iv) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

c. Whether an interest in real estate that is coupled with a rental arrangement will be deemed a security often depends upon whether a "common enterprise" or an "expectation of profits" is involved. The element of common enterprise is found in many federal courts only if there is "horizontal commonality," where the purchaser is subjecting his funds, together with those of other purchasers, to the risks of the enterprise. Thus, horizontal commonality is present when there is a horizontal relationship between the individual purchaser and the pool of other purchasers. The horizontal commonality test would certainly result in a finding of a common enterprise if a rental pooling arrangement were present. The lack of a pooling of rents has been held to defeat horizontal commonality, Revak v. SEC Realty Corp., 18 F. 3d 81 (2d Cir. 1994). In some federal circuits, however, a purchaser need only show "vertical commonality" where there is "promoter dominance," that is, when "the fortuity of the investments collectively is essentially dependent upon promoter expertise. In order for commonality to be found, these circuits do not require the purchaser's funds to be commingled with those of others. It should be noted that the vertical commonality test has been criticized as eliminating entirely the "common enterprise" requirement of the Howey test.

d. If the "common enterprise" element is present, a developer may still avoid a determination that an interest in real estate that is coupled with a rental arrangement will be deemed a security by addressing the expectation of profits element of the Howey test. Profit, for purposes of the Howey test, is generally viewed as either (i) capital appreciation from the development of the initial investment or (ii) participation in earnings resulting from the use of the investors' funds. United Housing Foundation v,. Forman, 421 U.S. 837,852 (1975). These are to be distinguished from the "general appreciation of the neighborhood." Id. The "expectation of profit" element of Howey is dependent to a large extent on promotional communications and activities relating to the offer and sale of real estate interests. Under Forman, personal use of housing and the lack of profit motive weighted heavily against application of the securities law. The court noted in Forman that, "when a purchaser is motivated by a desire to use or consume the item purchased – "to occupy the land or to develop it themselves," as the Howey court put it … -- the securities laws do not apply." Forman, 421 U.S. at 853. Another court also noted that, even where there is a generalized expectation of profit or loss depending upon real estate market factors, the profit motive for entering into the purchase of stock (or other interests in real estate) may be "purely incidental" if "the offering plan … is barren of any representation or intimation or anticipated profits" and contains "no references to the possibility or probability of profits." Grenader v. Spitz, 537 F 2d 612, 698 (2d cir. 1976).

e. The critical inquiry is whether the real estate interest were marketed together with the rental arrangement. While the mere presence of a rental program by itself may not lead a court to deem a sale of a real estate interest to be a sale of a security, if the rental program is emphasized in the offering presentation or otherwise marketed while selling the real estate interest, then there exists a suggestion of a commercial, or at least a non-personal, use. To avoid a finding of an expectation of profits, the existence of a rental program should not be mentioned as an incentive to purchase the real estate interest. Rather, the developer should emphasize the benefits of personal use and enjoyment. This prohibition on marketing of a rental program when selling an interest in real estate becomes even more important under the Hawaii Market Center test. The Hawaii Market Center test specifically requires an inducement by the offeror's promises or representations which may give rise to a reasonable understanding that a valuable benefit of some kind will accrue to the offeree as a result of the operation of the development. This inducement element can be avoided by having no "economic benefit" emphasis in the sale process.

f. In addition to the foregoing authority, the SEC has promulgated certain releases that have set forth the SEC's view of sale of condominium units or other units of a real estate development that are coupled with some form of rental arrangement. In this regard, the SEC has been involved to a far greater extent than the courts. In Release No. 33-5347, January 4, 1973, 38 F.R 1755 ("Release 5347"), the SEC stated that the sale of condominiums which are coupled with a rental arrangement would be deemed to be securities if they were offered and sold through advertising, sales literature, promotional schemes or oral representations which emphasized the economic benefits to a potential purchaser that would be derived from the managerial efforts of the promoter or a third party designated or arranged for by the promoter in renting the condominium units. Further, the SEC also provided three scenarios that, if used in conjunction with the offering of a unit of real estate, would cause such offering to be viewed as an offering of securities in the form of investment contracts. The three scenarios were set forth as follows.

(1) The condominiums, with any rental arrangement or other

similar service, are offered and sold with emphasis on the economic benefits to the purchaser to be derived from the a managerial efforts of the promoter, or a third party designated or arranged for by the promoter, from the rental of the units;

(2) The offering of participation in a rental pool arrangement; or

(3) The offering of a rental or similar arrangement whereby 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.

g. Additionally, in the same release, the SEC stated that if a condominium were not offered and sold with an emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of others, and if no plan to avoid the registration requirements of the Securities Act of 1933 were involved, an owner of a condominium unit might, after purchasing this unit, enter into a non-pooled rental arrangement with an agent not designated or required to be used as a condition to the purchase, whether or not such agent is affiliated with the offeror, without causing the sale of the unit to be construed as a the sale of a security, and set forth certain criteria, which, if followed, would keep the offered product from being construed as a security.

h. The SEC has had occasion over the past years to have reviewed and either granted or denied no-action comfort under Howey and/or Release 5347 with respect to several condominium or other real estate projects involving rental programs.

i. In a recent SEC no-action letter, the staff favorably applied a system of rational assignments that was designed to promote the fair allocation of rental space in a mixed-use, hotel-residential condominium building. In One Central Park West PT Assocs. L.P., Nov. 2, 1995, the SEC stated that this allocation arrangement did not violate the prohibition against income pooling arrangements as long as its availability was not emphasized during the sales pitch to potential purchasers.

j. In one of its most recent interpretations, the SEC issued a no action letter to Intrawest Corporation on November 8, 2002 wherein the SEC staff determined that Intrawest was not offering a security under the following circumstances. Intrawest uses its own staff to market and sell units in condominium resort projects. Intrawest's real estate sales staff mentions the availability of a rental program as one of several optional services available to purchasers, but if a purchaser seeks more detail regarding unit rental, the sales person suggests that the purchaser speak to either the affiliated rental management company located on premises or to an unaffiliated rental manager of his or her choice. Sales representatives do not discuss the economic or tax benefits that may result from entering into a rental arrangement, nor do they provide projections or other rental history information. This information is provided solely by the rental management company. Intrawest's affiliated rental management company will not enter into a rental management agreement with a purchaser before the purchaser enters into a purchase and sale agreement for the unit. This reinforces the position that the rental agreement is completely independent from the decision to purchase a unit. There is no pooling arrangement, the program is purely voluntary and the real estate sales representatives and rental management company representatives do not overlap, with each operation run separately and independently from the other. Real estate sales representatives do not receive additional compensation or other incentives as a result of individuals entering into rental management agreements with Intrawest's affiliate.

## D. Sales Programs

### 1. Timeshare and Fractional Offering Materials

a. Most states require that before interests in a timeshare project may be offered to residents of the state, public offering documents or a registration statement for the project must be filed and approved by a designated regulatory authority. Specific registration requirements differ in every state, and usually apply regardless of the jurisdiction in which the project is physically located.

b. The term "offer" tends to be defined rather broadly in these states, requiring registration before the developer may publish any advertisements in the state or engage in any in-state direct mail or telemarketing activities. Depending upon the state, a registration can be approved in as little as thirty days or can take as long as a year or more.

c. The documentation which most states require to complete a registration generally can be classified as title documents, disclosure documents and consumer documents. Title documents are those documents that are (or will be) recorded in the public records which establish the timeshare plan and/or encumber the timeshare property. Examples of title documents include declarations of covenants, conditions and restrictions; declarations of condominium; plats; easements; mortgages; and leases. Title documents required for various state registrations also may include the form deed that the developer intends to use to convey timeshare interests to purchasers, as well as a recent title report or attorney's title opinion with respect to the overall timeshare property.

d. Disclosure documents are those documents that are designed to fully and fairly describe to the purchaser material and other aspects of the timeshare plan. Disclosure documents may include public offering statements; registration applications; reservation system rules; resort regulations; homeowners association budgets and financial statements; and local government permits and approvals.

e. Where applicable, state law dictates the specific information that must be contained in a public offering statement or registration application, and usually requires, among other items, details about the use plan; the underlying legal structure of the project; the number, size and type of units to be constructed; the proposed date for completion of construction; the recreational facilities; the developer's financial strength and experience; the status of title to the timeshare property; descriptions of the general area surrounding the timeshare property; any agreements for the provision of management, utilities or other services to the timeshare property; exchange programs that may be available for use by purchasers; and any material or other "special risk" factors which might reasonably affect a prospective purchaser's decision to buy.

f. Consumer documents are those other documents that timeshare purchasers will be asked to sign in connection with the purchase of a timeshare interest. Consumer documents may include the purchase agreement and any addenda; purchase money financing documents such as the promissory note, mortgage and truth-in-lending disclosures; and the receipt for timeshare documents evidencing that the purchaser has received all of the disclosure documents and other materials required to be delivered by applicable law.

## 2. **Timeshare Registration**

a. Presently there is no uniform regulation and registration of timeshare and fractional structure, sales, marketing and operation on a federal level. Developers are faced with an array of regulations on a state by state basis. The regulation is often located within land sales registration statutes, although most of the major jurisdictions have timeshare specific statutes. A few states regulate the product under the state's securities statutes. A developer or its counsel must review state legislative statutes, administrative rules, and administrative forms to understand the full range of regulation. In addition, in some states there is additional timeshare regulation at the local or municipal levels.

b. The various states that regulate the timeshare and fractional industries take varied approaches toward the regulation. These approaches fall along a continuum that ranges from a pure disclosure oriented approach to a substantive approach that reviews and passes judgment about whether a type of structure or aspect of the timeshare project will be permitted in that state.

c. Florida and California are symbolic of these different approaches. With almost a quarter of all resorts and units in the U.S. timeshare industry, Florida is the largest situs state market for the timeshare product. California is the second largest situs state market. Florida's approach is primarily a disclosure-oriented regulatory structure. California takes a much stricter approach, examining each structure to determine, in the regulator's opinion, whether aspects of the plan are a "reasonable arrangement" that the state will permit to be offered to its citizens.

d. Despite the different approaches, the legislative and regulatory approach of each jurisdiction typically attempts to address most of the following items:

(1) Full and fair disclosure to prospective purchasers of the timeshare plan about the product that the consumer is purchasing and any limitations on that product through required developer filings of public offering documents and contract disclosures.

(2) Creation of rescission rights in the purchaser's contract for a specified number of days ranging from four days to fifteen days.

(3) Requirement of escrow of the consumer's money until, depending on the state, the rescission period is passed, the product is constructed, closing has occurred and/or the developer is able to deliver the product promised to the consumer.

(4) Requirement of financial assurance or other protection of accommodations and facilities from interest holders to ensure that the accommodations and facilities are free and clear of any encumbrances or are the subject of a non-disturbance or subordination agreement.

(5) Requirement of one-to-one purchaser to accommodation ratio.

(6) Regulation of management and budgeting of timeshare plan operations.

(7) Regulation of the exchange of timeshare interests.

(8) Regulation of marketing and advertising.

## 3. Sales and Marketing Practices

a. Sales and marketing activities are closely regulated by both federal and state laws, since it is this area that has been the most abused by the timeshare industry in the past. In addition to avoiding the penalties prescribed by the various laws, both the developer and the managing entity will want strict compliance with these laws in order to avoid bad publicity and ensure marketability of the developer's mortgage portfolio.

b. *Federal and State Fair Housing Acts* — Federal and State Fair Housing Acts specifically prohibit discrimination against a person in any of the terms, conditions or privileges connected with the sale or rental of a dwelling on the basis of age, race, color, national origin, sex, handicap, familial status or religion. In addition, both acts prohibit the printing or publishing of any notice, statement or advertisement that tends to indicate any preference or limitation based on any of the protected categories. These acts apply to timeshare sales and solicitation activities by a marketing group, including target market qualifications, advertising, and gift promotional efforts.

c. *Federal Trade Commission ("FTC")* — The United States Congress has granted various powers to the FTC to generally regulate trade and commerce for the protection of consumers. With respect to marketing and advertising, the FTC has promulgated specific rules and regulations making it a violation to engage in "unfair and deceptive trade practices." The FTC and the courts have interpreted the powers granted to the FTC very broadly, and have often regulated the activities of the merchant rather harshly in providing for consumer redress. Penalties are severe and harsh and include injunctive relief, issuance of cease and desist orders and other affirmative relief. In addition to the federal legislation in this area, most states have passed their own marketing and advertising laws (commonly known as the "Little FTC laws") with similar requirements and penalties.

d. *State Brokerage Statutes* — State brokerage statutes typically require that all persons who act as a "broker" or "salesman" must be licensed by the state regulatory agency. These terms extend to almost anyone involved in the selling or leasing of real property, including, but not limited to, salesmen, sales managers, OPC (the term given to the procurement of consumers to take timeshare sales tours), on-site brokers, rental reservationists, and telephone solicitors. There are often limited exemptions for certain salaried employees of the owner of the real estate, salaried condominium managers and timeshare solicitors (who may need to be licensed separately). All of the employees who participate in selling or leasing in any manner should be evaluated regarding the applicability of State brokerage statutes.

e. *Seller of Travel* — Some states have seller of travel laws requiring that all persons or business entities who directly or indirectly offer prearranged travel or tourist-related services for a fee or commission be registered as a "Seller of Travel" and post a performance bond or other alternative assurance. All prearranged travel packages being offered must be filed with the appropriate regulatory agency prior to sale for approval.

f. *Timeshare Advertising Provision* — Some states specifically regulate the advertising activities that may be conducted in connection with the sale of timeshare interests. These states define what constitutes "advertising" and prohibit the making of certain types of representations. Further, some states require a developer to register all advertising materials with the regulatory agency prior to use. The developer may also be faced with specific regulations governing sweepstakes and prize and gift promotions conducted in connection with the sale of timeshare interests.

g. *Out of State Registrations* — With regard to <u>any</u> sales or marketing activities, most states require advance registration prior to commencing such activities even though the resort is located in another state. Each state's timeshare law varies with some states such as New York, New Jersey and California having strict regulations and others such as North Carolina and Georgia having relatively weak regulations. Failure to register a timeshare plan in a given state prior to commencing sales or marketing activities may result in severe penalties and damage future sales in those states.

h. *Federal Telemarketing Regulations* - The Federal Trade Commission ("FTC") is the federal agency responsible for enforcing the Telemarketing Sales Rule, 16 C.F.R. § 310, which requires telemarketers to make specific disclosures to consumer and prohibits listed deceptive or abusive telemarketing acts and practices. The FTC recently amended the Telemarketing Sales Rule, which amendments: (i) establish a national do-not-call registry to which consumers may prescribe without any cost; (ii) prohibit contact with those listed on the do-not-call registry, with limited exceptions; and (iii) require an additional disclosure in connection with prize promotions. Contacting a person listed on the do-not-call registry is deemed an abusive telemarketing act or practice and penalties for violations of the Telemarketing Sales Rule can result in fines of up to $11,000 per violation. The Federal Communications Commission ("FCC") has also recently released its final rules implementing the Telephone Consumer Protection Act, 47 U.S.C. §227. The FCC attempted to harmonize its rules with the FTC rules discussed above and the FCC rules contain specific provisions regarding the national do-not-call registry, predictive dialers, abandoned calls, prerecorded messages, caller ID devices, and unsolicited facsimile transmissions.

i. *Additional Regulatory Considerations* — Once a timeshare registration is filed and approved in a particular state, there may still be other regulatory hurdles the developer must overcome before proceeding with its sales and marketing plan. Specifically, many states have general consumer protection laws that are not specific to timeshare, but which nevertheless govern the developer's proposed promotional activities. The most common types of these laws apply to telemarketing, "home solicitations," "promotional offers" and gambling. Most states have telemarketing laws which require any person or company that intends to tele-market into the state to complete a registration with a designated state regulatory agency. Many states further require that as part of the registration process, the telemarketer post a substantial bond. Various state telemarketing laws also set forth behavioral and disclosure guidelines which complement those established by federal law, to which all telemarketers are required to adhere.

j. "Home solicitation" laws are special laws which apply to the sale of goods and services to a purchaser when that purchaser is solicited in his home. Initially enacted to apply to door-to-door salesmen, a number of states have expanded their laws to include sales made over the telephone to purchasers in their home. Most home solicitation laws require that a written contract be utilized and that the purchaser be granted the right to cancel the transaction for any reason during a statutory cancellation period. In addition to potentially applying to the actual sale of timeshare interests, home solicitation laws also apply to the sale of discounted mini-vacation packages designed to induce a prospective timeshare purchaser to visit the resort.

k. "Promotional offer" laws generally are disclosure-oriented laws designed to ensure that consumers are provided with all relevant details regarding offers which appear "too good to be true." Examples of promotional offer laws include statutory limitations on the use of words like "free" and requirements that promotional offers include a disclosure regarding the identity of the promoter and the purpose for the promotion. Some promotional offer laws further require some form of registration with the state attorney general's office or some other designated regulatory authority.

l. Gambling laws are those laws that regulate or prohibit gambling, lotteries, drawings and the like. Many promotional offers involve a giveaway, which under some state laws, could be deemed an illegal lottery. While exemptions do exist in many cases for retail-related giveaways, these exemptions often contain specific requirements regarding how the drawing must be conducted and disclosure requirements regarding the purpose for the drawing and the value of the prizes. In some instances, registration of permitted promotional giveaways with a regulatory authority also is required.

4. **Securities Laws**

a. *Federal Securities Laws* — The Securities and Exchange Commission (the "SEC") and the federal courts that have addressed timeshare plans have looked closely at the kind of product being offered, trade activities of the developer, marketing literature and rental activities to determine whether the interest conveyed constitutes a security. In so doing, the SEC and the federal courts have created various and differing tests through releases, no-action letters and court opinions.

b. Because of the difficulties inherent in registering a timeshare plan as a security (especially with respect to marketing guidelines), the most practical alternative is to create and market a timeshare product that would not constitute a security under the federal securities laws. Significant consideration must be given to the federal securities aspect of the development of timeshare plans. Major securities flashpoints in the timeshare industry include discussions at the point of sale of rental or resale potential, owner referral programs, and other income-oriented opportunities. The more a product is promoted and designed for personal use and consumption, the less likely it is to be found to be a security.

c. If a product is determined to be a security, the penalties are extremely harsh for the developer and for anyone selling such a product. Penalties include, but are not limited to, rescission rights granted to purchasers, the return of all the monies received from purchasers, punitive damages, SEC injunctive relief, and criminal penalties.

d. *State Blue Sky Securities Laws* — In addition to the federal securities laws, each state has its own "blue sky" regulations which may be applicable to the sale of timeshare interests in that state or to that state's residents. The individual states will look at such factors as risk capital considerations, conveyancing documents, marketing techniques, and product structure to determine if the timeshare interest conveyed constitutes a security. Penalties under various state laws are similar to those provided under federal laws, including, but not limited to, rescission rights, punitive damages, injunctive relief, and criminal penalties. A few states treat all timeshare plans as securities and require the disclosure of "special risk factors" to purchasers. Marketing techniques and product structure are particular focus points of any blue sky securities analysis.

## 5. Additional Laws and Legal Issues

a. *Interstate Land Sales Full Disclosure Act ("ILSA")* — ILSA is a federal law that requires land developer registration with the Secretary of Housing and Urban Development and the delivery of a property report to all purchasers of subdivision lots, including purchasers of condominium units. Among the statutory exemptions from ILSA compliance is an exemption for developers who contractually obligate themselves to complete the unit being sold and all other promised improvements within two years of the date of contract. Timeshare developers typically utilize this exemption. Purchase agreements may not limit the buyer's remedies in the event of a seller's default; otherwise, the two-year construction exemption is forfeited. Failure to comply with the Act or to fall under an applicable exemption renders all purchase contracts voidable by the purchasers.

b. *USA PATRIOT Act of 2001 ("Patriot Act")* – The Patriot Act is the federal legislative response to the terrorist attacks of September 11, 2001. The Patriot Act applies to "financial institutions" as that term is defined under the Bank Secrecy Act, 12 U.S.C. §§ 1951-59 and 31 U.S.C. §§ 321, 5311-14, 5316-22, which definition includes not only traditional financial institutions such as banks, but also includes entities not normally thought of as financial institutions such as "persons engaged in real estate closings and settlements" and "loan or finance companies." Because this definition of "financial institutions" is very broad, it will likely encompass many timeshare companies that develop, market and/or sell real property interests or provide purchase money financing to their purchasers. The Patriot Act has two sections which may particularly affect timeshare developers. Section 352 of the Patriot Act requires all financial institutions to adopt anti-money laundering programs that include specific features as outlined in the section. While many the traditional financial institutions have already been subjected the requirements of Section 352, other categories of non-traditional institutions, including those that would encompass timeshare companies, have been exempted from regulation until the Department of the Treasury can develop risk-appropriate regulations. Whether and to what extent timeshare developers will be required to comply with Section 352 remains to be seen. Section 314 of the Patriot Act allows the Financial Crimes Enforcement Network ("FinCEN"), on behalf of other federal law enforcement agencies, to require a financial institution to search its customer and employee records and identify accounts of, or transactions with, individuals or entities that have been certified as, or reasonably suspected of, engaging in money laundering or terrorist activities. To date, Section 314 has only been enforced against the more traditional financial institutions; however, FinCEN has specifically reserved the right to require any financial institution to comply with Section 314. Penalties for violations of the Patriot Act are severe and include the freezing and forfeiture of assets, fines of up to $1,000,000 and up to 20 years' imprisonment for individual violators.

c. *Executive Order 13324 ("Executive Order")* – The Executive Order issued by President Bush on September 24, 2001, mandates that no U.S. company will do business with any person that has committed or poses a risk of committing or supporting terrorist acts and those identified on the list of Specially Designated Nationals and Blocked Persons, generated by the Office of Foreign Asset Control ("OFAC List"). Unlike the Patriot Act, the Executive Order currently applies to all U.S. companies, not just financial institutions. Timeshare companies must consult the OFAC List to ensure that they are not selling timeshare interests to any person or entity on the list. As with the Patriot Act, penalties for violations of the Executive Order are severe and include the freezing and forfeiture of assets, fines of up to $500,000 and up to 10 years' imprisonment.

d. *Public Lodging Statutes* — Public lodging statutes prescribe regulations with which every public lodging establishment, including timeshare resorts offering transient rentals, must comply. These regulations address such issues as maintenance of a guest register; liability for guests' personal property; refusal of service; posting of room rates; advertising; telephone surcharges; safety; fire safety; and sanitary facilities.

e. *Brokerage Statutes* — Brokerage Statutes require licensure of any entity responsible for rental of real property interests. A managing entity's handling of the developer's rental program and the future rental activities of specific owners dictates that this law be examined closely for application. See the discussion of Brokerage Statutes in the Sales and Marketing section below for details.

f. *Americans with Disabilities Act ("ADA") - Title I*— The ADA is a federal law. Title I of the ADA prohibits discrimination by private and public employers against qualified individuals with disabilities in all aspects of employment, including job application, hiring, advancement, discharge, compensation and training. Title I further imposes upon employers an affirmative duty to make reasonable accommodations for the disabled. The managing entity as an employer will be subject to this law.

g. *Real Estate Settlement Procedures Act ("RESPA")* — Depending on whether the product to be sold is a deeded product or a right-to-use product, RESPA may be applicable. RESPA provides for the regulation of "federally related mortgage loans" which are described as loans that are secured by a first lien on residential real property designed principally for the occupancy of one to four families, if such loans are extended by "creditors". "Creditor" is defined as a person who makes or invests in residential real estate loans in the aggregate of more than $1 million per year. The enforcement agency for RESPA is the Department of Housing and Urban development ("HUD"). Consistently HUD's position has been to include "timeshare interests" within the coverage of RESPA, since developers generally fall within the definition of creditor. However, there are strong arguments that it should not apply to a right to use product. RESPA has various provisions which relate to disclosures at the time of a loan application, disclosure statements required at the time of closing, servicing of loans and prohibition against certain kinds of activities such as those related to "kick-backs" and fraud. Most of RESPA's provisions are technical in nature and carry specialized meanings often quite different from the commonly understood meanings of such terms. Therefore, RESPA is applicable at all stages of creation, maintenance, and sales activities with respect to timeshare interests.

h. *Truth-in-Lending Act ("TILA"*) — TILA is the principal federal law governing creditor disclosures to consumers in consumer financing transactions. The TILA disclosure requirements are specific and must be strictly followed, especially with respect to disclosures related to interest rates. Because TILA is primarily geared toward disclosures to the borrower, inadequate, incomplete or absent disclosures can result in enforcement penalties, criminal liability, civil liability and/or costs and attorneys' fees.

i *The Equal Credit Opportunity Act ("ECOA")* — ECOA regulates the extension or failure to extend credit based on discrimination related to race, color, religion, national original, age, whether all or a part of an applicant's income derives from public assistance, and whether the applicant has, in good faith, exercised any right under the Consumer Credit Protection Act. The legislation requires certain disclosures and notices. The rules under ECOA relate to the preapplication stage of credit, application stage of credit, evaluation stage of credit, extension of credit, record retention, furnishing of credit information, and coordination with state laws.

j. *Fair Credit Reporting Act ("FCRA")* — Depending upon how the credit information obtained by the timeshare developer is used, FCRA may be applicable. The intent of FCRA is to control the collection and dissemination of information about consumers in a wide range of situations, including the granting of credit, eligibility for insurance and decisions as to employment. The penalties under the statutes and regulations include administrative enforcement, civil liability and criminal liability.

k. *State Consumer Laws* — Specific state consumer laws also need to be considered. Many states have enacted some version of the Uniform Consumer Credit Code, which provides for documentation, disclosure and notice requirements in consumer transactions. It also provides certain private rights of action to the consumers and grants enforcement powers to regulating agencies to bring actions on behalf of consumers. Penalties often include injunction, rescission rights, and actual and punitive damages. States that have not enacted the Uniform Consumer Credit Code have in turn provided their own consumer protection legislation which may be more or less restrictive depending upon the legislative intent.

l. *Americans with Disabilities Act ("ADA") - Title III* — Title III of the ADA requires providers of public accommodations to make their goods and services accessible to individuals with disabilities so that the disabled may have equal access to all private establishments that are available to the public. The definition of "public accommodations" is extremely broad and includes places of lodging, which may mean timeshare resorts. Providers of public accommodations have an affirmative duty to make reasonable modifications in physical structures, policies, practices, or procedures in order to make their goods and services available to individuals with disabilities, and all new construction or alterations of facilities must be done in such a manner as to render them readily accessible to the disabled. Particularly important to timeshare resorts that will have recreational facilities such as golf courses, swimming pools, boating facilities, or exercise equipment, the Architectural and Transportation Barriers Compliance Board recently issued a final rule regarding accessibility guidelines for new construction and alterations of such recreational facilities. Some of the key features of the accessibility guidelines include: (i) provisions requiring minimum numbers of spaces or facilities for wheelchairs; (ii) accessible routes to and from the facilities; (iii) requirements for wheelchair transfer devices; and (iv) sloping requirements. While the guidelines have been issued as a final rule, compliance with the guidelines is not required until the Department of Justice ("DOJ") adopts the guidelines as part of its ADA regulations. As of yet, the DOJ has given no indication when the guidelines will be adopted.

## E. Branding and Licensing Issues

### 1. Brand Participation

a. Much of the recent growth in the timeshare and fractional industries has been as a result of the entry of major hospitality brands such as Marriott, Hilton, Hyatt, Westin, Four Seasons and Ritz-Carlton, among others. The entry of major brands into the industry help to legitimatize the timeshare product and bring credibility to the industry. Marriott Vacation Club presently has annual timeshare sales exceeding $1 billion.

b. High-end brands such as Four Seasons and Ritz-Carlton do not sell traditional timeshare products, but rather offer fractional interests and private residence club concepts.

### 2. Brand Affiliation

a. Most of the major brands are the owner/developer of their timeshare and fractional interest projects and do not follow the traditional hotel model wherein the brand attaches to the hotel through a management agreement or franchise agreement.

b. The primary reasons attributed to this are the relatively small profit margin on pure management of timeshare resorts, the need of the brand to control the sales and marketing process and the significant profit to be made on the developer financing of the purchase of timeshare units.

c. Some hospitality brands are willing to joint venture with developers on timeshare or fractional products provided that the brand controls the sales and marketing process and is able to hypothecate or securitize the timeshare receivables through its existing financing facilities.

d. A few hospitality brands such as Carlson (“Radisson”) and Wyndham have entered into franchise arrangements with timeshare developers with existing track records wherein the developer pays the brand a percentage of the gross revenue of timeshare sales in consideration for a license of the brand name and marks. These agreements may or may not include additional brand support such as marketing programs and channels, purchasing of supplies, rental of unsold inventory and rights to participate in the brand’s loyalty programs.

## F. Owners' Associations

### 1. Operations

a. A managing entity operates and maintains a timeshare or condominium project. The managing entity can be the developer, a separate manager or managers, or owners' associations of some type. In most instances, the developer will form at least one condominium or other type of owners' association to manage the project prior to offering interests in the project. This is intended, among other things, to shift the responsibilities and liabilities of managing the project from the developer to another entity, although the developer may not be relieved of many of these responsibilities by statute while it controls the board of directors for the association (as further discussed in Section G.3.). The association in turn usually enters into a management agreement or agreements in order to delegate some or as many of its rights and responsibilities as legally possible to a separate manager or managers. These managers further may sub-contract or assign some or all of their rights and responsibilities under the management agreements. Most associations employ managers because the associations and their government boards do not generally have the capabilities or the experience to operate and maintain the projects.

b. Certain jurisdictions may require that an association act as the managing entity of a timeshare or condominium project, although there may be no mandate that the association is a corporation. However, even if there is no such legal requirement, the developer usually forms the association as a separate corporation to isolate any liability attributable to the association in a corporate entity. Most lenders in fact will require that the association be formed as a corporate entity for this reason. The association generally is formed as a not-for profit corporation as an attempt to (i) avoid adverse tax treatment as a for-profit entity; and (ii) militate against potential securities concerns which may more easily be attributed to a for-profit entity.

c. The types and numbers of associations formed to manage a timeshare or condominium project will depend on how the developer chooses to set up the project. No matter what type of timeshare or condominium project, the developer may choose to form only one owners' association which operates and maintains all facets of the project. This association would be a hybrid timeshare/condominium association in the case of a timeshare condominium, a hybrid timeshare/homeowners' association on the case of an undivided interest timeshare project, a timeshare association in the case of a right-to-use or license project, and a condominium association in the case of a non-timeshare condominium.

d. The developer of a timeshare condominium or an undivided interest timeshare project may elect to have a timeshare association and a condominium association or homeowners' association, respectively, perform different functions in the operation and maintenance of the project. For example, the timeshare association may be responsible for operating the reservation system and related functions of the project, while the condominium association or homeowners' association is responsible for more of the traditional types of condominium or homeowners' association operational and management functions. Most developers prefer to limit the number of associations which are formed due to costs and complexity, which tend to disincentivize purchasers. On the other hand, the developer may find it necessary to form two associations in order to preserve flexibility for future sales if phasing is not permitted under applicable law.

e. A developer may choose to form an undivided interest project (which is not subjected to the condominium form of ownership) in an attempt to avoid what it may view as cumbersome requirements of a condominium statute. However, under that scenario and depending on the jurisdiction, the developer may be depriving itself of the comfort of the somewhat greater certainty afforded by a condominium statute a opposed to another homeowners' association statute or common law. Further, if no such common homeowners' association or common law is instructive on a given point, a court may look to condominium law to provide a resolution. Moreover, in certain jurisdictions a timeshare statute may preempt a condominium statute on certain association issues, which may vitiate the argument against using a condominium association. In any event, the developer should consult competent legal counsel to assist in the careful analysis of these issues.

f. A developer of a timeshare or condominium project which is or may become part of a mixed-use development also faces further challenges of how best to integrate the project-specific association(s) with a master association or association(s) for the overall development. Developers often subject such developments to a master declaration of covenants, conditions, restrictions, and easements in an attempt to share costs of commonly used facilities and to control the quality of the development, among other reasons. The developer responsible for the overall development (which may or may not be the timeshare developer) will need to determine, again among other things, whether one or more master associations are needed and if so what type of entity should be formed with respect to each such entity, what functions each master association and the specific association(s) for the project should perform, whether any entity will have lien and assessment rights over the entire development, how such assessments are treated by the specific association(s) for the project, the requirements for membership in each master association, and the relative voting rights of the members of each such association. If the project developer is not the developer of the overall development, the project developer will want input and should be consulted regarding these issues. Although beyond the scope of this presentation, this subject deserves considerable attention and discussion.

## 2. **Third Party Management**

a. Most developers prefer to have affiliated managers operate and maintain their timeshare or condominium projects. This primarily is due to the often lucrative management fees which a manager may earn. The developer also may view this arrangement as an attempt to ensure that the quality of the project is maintained. Many jurisdictions require that such an arrangement be disclosed to purchasers as part of the management agreements or offering documents. Some timeshare and condominium projects are managed by managers which have an affiliation with a national or international brand. In such instances, the manager may or may not also be affiliated with the developer. Please refer to Section F. for further discussion of branding issues.

b. The rights and responsibilities of an owners' association which may be delegated to a manager are often prescribed by statute, and may further be set forth in the governing documents of the timeshare or condominium project. As a general matter, most of the association's responsibilities for the day-to-day operations of the project may be delegated to the manager; however, the association may not be able to delegate responsibilities for the adoption of the association budget or the promulgation of rules and regulations for the timeshare or condominium project, as in Florida. The manager also likely will have a fiduciary duty to the owners of the project which it probably will be unable to avoid by contract. The manager should be aware that some jurisdictions also require that certain expenses of the association must be sent out for competitive bid. The term and termination requirements of a management agreement for a timeshare or condominium project often are prescribed by statute, and in some jurisdictions are more favorable for managers of timeshare projects than for other types of projects such as non-timeshare condominiums.

### 3. **Turnover Issues**

a. Developers often want to keep control of an association in order to ensure future sales. A developer-controlled association is more likely to be able to control expenses of the association (including preventing the levying of assessments to fund litigation against the developer), and control amendments to the governing documents, particularly any such amendments which would compromise the quality of the project. Accordingly, many developers seek the flexibility to maintain control over the association for as long as they can. The timing of the transition of control of the owners' association of a timeshare or condominium from a developer-controlled association to an owner-controlled association (also known as "turnover"), however, may be governed by statute or by the governing documents of the project. In many jurisdictions, statutorily set time periods limit turnover time periods which may be set forth in the governing documents.

b. Each developer should weigh the pros and cons of maintaining control of the owners' association of a timeshare or condominium project against those of turnover. Many developers consider turnover as a method of achieving a key developer objective of limiting liability, especially as in certain jurisdictions the developer has a fiduciary duty to the owners of the timeshare or condominium project during the time that the developer controls the association. It is important to note, though, that turnover itself does not necessarily terminate the developer's liability for, or ratify, the acts of a developer-controlled association. Rather, turnover may trigger the statute of limitations against the developer for any violations of a developer-controlled association, or may hasten the expiration of certain statutorily imposed warranties of the developer. In addition, a developer should consider that some jurisdictions, such as Florida, set a time limit after turnover for the owner-controlled board of directors of a condominium association to reject certain agreements of the developer-controlled board.

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5th Annual Hospitality Law Conference
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A Course of Lodging Delicacies

Time Share & Fractional Issues

Presented by:
John Melicharek

**John Melicharek**

- Partner with Baker & Hostetler
- John is a Hospitality Industry Team Leader and has been advising clients for over twenty years on business and transactional matters
- He maintains a diverse real estate and business practice with a strong emphasis on resorts, hotels and the travel and leisure industry.
- He is a member of the American, Florida and New Jersey State Bar Associations and is actively involved in the Urban Land Institute—Recreational Development Council and the Organization for Timeshare in Europe.

## Timeshare and Fractional Resort Development & Sales

presented by
John Melicharek, Jr.
Baker Hostetler LLP

## What is Timeshare

- The subdivision of property into increments of time - a stripping of the use function from the real estate and carving it up into time periods
- A week is the most commonly used time period

## Why are Developers Choosing Timeshare?

- Timesharing is financing – Most of developer's profit is made on spread between interest charged to buyers and interest paid on credit line
- May give up ownership of the property, but often can retain profit centers and management of property (Fee = 10-15% of HOA Budget)
- Build brand loyalty
- Increased occupancy percentage
- Increased use of adjoining facilities (golf courses, restaurants)

## Current State of the Timeshare Industry

- $8.6 billion of timeshare interests were sold in 2005
- Industry has recorded double-digit growth in 16 of the last 17 years
- 80.3% of timeshare owners express satisfaction with their timeshare purchase
- Median household income of timeshare owners is $81,000.00

## Where are Timeshare Resorts Located?

- 31.9% Beach/Ocean
- 13.7% Regional
- 10.2% Golf
- 9.3% Snow Skiing
- 9.0% Lake/River
- 6.0% Urban
- 5.3% Theme Park

## Branding and Licensing Issues

- The emergence of major brands in the 1980's and 1990's such companies as Marriott, Hilton, Hyatt, Westin, Four Seasons and Ritz-Carlton helped to legitimatize the timeshare industry
- Many high-end brands sell timeshare and fractional products in addition to other vacation products

## Structure of Timeshare Interests

- Timeshare interests are structured as either timeshare estates or as timeshare licenses
- Purchasers of timeshare estates receive a deed that includes all of the rights and liabilities associated with owning real property
- Purchasers of timeshare licenses receive contractual use rights and few, if any, of the rights associated with owning real property

## Real Property Interests

- Most common approach in the United States is for the developer to submit all of its fee simple title in the property to a condominium based timeshare regime (usually in phases).
- Developer overlays a timeshare declaration further encumbering the property.
- As the developer sells its timeshare inventory and liens must be released as to the sold interests.

## Advantages of Timeshare Estates

- Tax and accounting advantages
- Securities safe harbor
- Lender and rating agency acceptance
- Regulator familiarity
- Pride of ownership
- Owner democracy

## Timeshare Regimes

- Four common types of timeshare regimes

  Undivided interest ownership

  Condominium form of ownership

  Cooperative form of ownership

  Trust vehicle

## Timeshare Use Plan

- The use plan is the rules or covenants that govern and describe how and when timeshare owners may use the timeshare resort's accommodations and facilities
- Simpler use plans are inexpensive to create but allow little flexibility
- Use plans which provide more flexibility tend to be more complex and expensive to create

## Examples of Timeshare Plans

- Fixed Week/Fixed Unit: buyer stays in designated unit during specific time each year (least flexible)
- Fixed Week/Floating Unit: buyers have the right to occupy a particular type of unit during a specific time each year
- Floating week: buyer gets right to reserve same unit type during a specific season or block of time
- Point system: owners receive points (administrative currency) which can be used for making reservations (very flexible)

## Vacation Clubs

- Vacation clubs allow purchasers the opportunity to stay at multiple locations
- Vacation clubs allow developers to establish a brand and provide customers with consistent service and quality among resorts in the Club
- Marriott, Hyatt, Hilton, Starwood, Wyndham and Disney all operate vacation clubs

## Fractional Projects

- Purchasers receive an undivided fractional or percentage ownership of a unit or accommodation, usually for between four to twelve weeks
- Fractional interests tend to be higher-priced products targeted at wealthier purchasers
- Usually involve lower marketing costs

## The Applicability of Securities Law to Timeshare

- In some situations, the sale of real estate can be deemed a security
- Must be cognizant of both federal and state law
- Howey Test: an investment contract involves an (1) investment of money, (2) in a common enterprise, (3) produced by the efforts of others, (4) with an expectation of profit.

## Timeshare Registration

- States typically require that timeshare projects must first be registered before they may be offered to residents
- Registration usually involves submitting title documents, disclosure documents, purchase contracts, management agreements and consumer protection documents

## Sales and Marketing Practices

- Both state and federal laws regulate the sales and marketing of timeshare
- Examples include federal and state fair housing acts, prohibitions on unfair and deceptive trade practices, state brokerage requirements, and specific state laws regulating timeshare promotion, marketing and advertisements

## Additional Laws and Legal Issues

- Interstate Land Sales Act
- USA Patriot Act of 2001
- Executive Order 13324
- Public Lodging Statutes
- Americans with Disabilities Act ("ADA")
- Real Estate Settlement Procedures Act ("RESPA")
- Truth-in-Lending Act ("TILA")
- The Equal Credit Opportunity Act ("ECOA")
- Fair Credit Reporting Act ("FCRA")