FRACTIONAL 102
A COMPLETE PRIMER ON LEGAL ISSUES IN FRACTIONAL DEVELOPMENT AND SALES

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I. REGULATORY BARRIERS TO CREATING A FRACTIONAL OWNERSHIP PROJECT

A. Timeshare/Fractional Development Regulations

(1) Applicability of Timeshare/Fractional Development Regulation

(a) Does not depend on whether you call it a "timeshare"

(b) Need to look at how the regulation defines timeshare

(c) Sometimes project can be structured to avoid or minimize effect of regulation

(2) Types of Timeshare/Fractional Development Regulation

(a) Can be private, local, state or national

(b) Styles of regulation

(i) Outright prohibitions

(ii) Location limitations

(iii) Number of interval/owner limitations

(iv) Structure/organizational requirements

(v) Usage limitations

(vi) Registration/Approval requirements

(vii) Disclosure requirements

(viii) Rescission rights and notices

(3) General Considerations On Timeshare/Fractional Development Regulation

(a) Can sometimes be circumvented by altering project size or structure

(b) Risk of pretending that shared usage is not an element of offering in order to avoid application of provision

(c) Potential risks of trying to fly "under the radar" and related disclosures requirements

(4) Private Timeshare/Fractional Development Regulation

(a) Problem only for fractional within an existing development

(b) Need to review all HOA governing documents

(c) Even if no clearly applicable provision, need to consider whether other owners or Board could use a creative interpretation, or amend the documents

(d) Should potential for problems with HOA be disclosed? If so, how should they be disclosed?

(4) Local Timeshare/Fractional Development Regulation

(a) Need to check local zoning and use laws

(b) Can be either county or municipal jurisdiction

(c) May also be Coastal Commission or other unusual entity with regulatory authority

(5) State Timeshare/Fractional Development Regulation

(a) Consider timelines and costs of process

(b) Need to check subdivision laws

(c) Extra requirements may apply of fractional is within existing development

(6) National Timeshare/Fractional Development Regulations

(a) U.S. national laws generally do not apply

(b) Most foreign countries have only disclosure-related requirements

II. REGULATORY BARRIERS TO MARKETING FRACTIONAL OWNERSHIP INTERESTS

A. Preliminary Consideration On Marketing Regulations

(1) Need to determine how and where interests will be sold

(2) Public versus private offering

(3) Use of sales agents

(4) Internet

(5) Email correspondence

(6) Postal Mail/Telephone solicitation and follow-up

(7) Local vesus national media

(8) Where contract is signed

(9) Where check is written

B. Timeshare/Fractional Marketing Regulations

(1) Based on state law

(2) Applicability based on how and where project will be marketed

(3) Can be registration/approval requirements, disclosure requirements, rescission rights and notices, or combination

(4) Some states will honor other state's approvals, or diminish requirements based on other state's approval

(5) States can also limit who may sell or impose licensing or registration on salespeople

(6) Can sometimes be circumvented by altering project size or structure

C. Securities Marketing Regulations

(1) Based on state and federal law

(2) Is offering a security?

(a) Generally no definitive answer; difficulty of getting regulatory agency or court to make characterization

(b) Fact that real estate is being conveyed does not mean it isn't a security

(c) Major considerations in security characterization

(i) Rent pooling

(ii) Promotion as investment

(iii) Level of owner control

(3) Effects of security characterization

(a) Registration requirements

(b) Keeping offering private

(c) Limits on who can buy

(d) Licensing requirements for salespeople

III. FRACTIONAL OWNERSHIP LEGAL STRUCTURES

A. Overview of Ownership/Membership Options

(1) Ownership versus right to use

(a) Concept of licensing

(i) Destination club concept

(ii) Prepaid vacations

(iii) Other club variations

(b) Ownership involving a lease

(i) Why underlying property might be leased

(ii) Protecting owners where lease is involved

(c) Separating ownership and usage rights

(i) How ownership and usage can be separated

(ii) Using ownership/usage separation to deal with widely differing usage intentions

(iii) Using ownership/usage separation to deal with regulatory problems

(2) What you own versus how you own it

(a) What—unit specific or not

(b) How--directly (on title) or indirectly (entity owns property)

(c) Choices do not determine whether it is a time-share

B. What The Fractional Owners Own and Use

(1) To own specific unit in a multi-unit project, must be subdivided

(2) Unit-specific ownership versus unit-specific usage

(3) Unit-specific ownership versus unit-specific maintenance

(4) Advantages of specificity of usage/maintenance

(a) Way to deal with units that differ

(b) Allows difference in decorating/amenities/pricing

(c) Simpler usage systems lower cost

(d) Owner always or mostly use same unit

(e) Smaller group of users and decision makers

(f) More independence and more control

(g) Can be combined with exchange program with other units

(5) Advantages of non-specificity of usage/maintenance

(a) Fewer choices for buyers

(b) Less difficulty in pricing

(c) Owner has higher probability of getting desired usage dates

(d) More owners to share risks of loss/damage

(6) Partial specificity of usage/maintenance

(a) Grouping certain units together

(b) Dealing with assessments, decision-making, segregation of funds, liquidation

C. How The Fractional Owners Own

(1) Introduction to direct versus indirect ownership

(2) Advantages of direct ownership

(a) Better tax treatment in general (if domestic property)

(b) Market preference

(c) Fractional financing more likely

(3) Advantages of indirect ownership

(a) Eases enforcement and transfer if foreign property

(b) Can facilitate group lending

(c) Built-in owner liability protection

(4) Misconceptions about direct versus indirect ownership

(a) Does not determine whether it is timeshare

(b) Does not usually determine whether/how regulated

(c) Does not avoid application of due on sale clause

(d) Does not protect seller or re-seller from liability

(5) Direct Ownership--Organizational Structure and Documents

(a) Protection from owner liability with direct ownership

(b) Recorded versus unrecorded documents

(c) Foreclosure by HOA and lenders in direct ownership

(6) Indirect Ownership--Organizational Structure and Documents

(a) Profit versus nonprofit-resulting limitations

(b) Foreclosure by HOA and lenders in indirect ownership

IV. FRACTIONAL OWNERSHIP GOVERNING DOCUMENTS

A. Purpose and timing of documents

(1) How/when documents are typically used

(2) Adapting document structure/length to likely usage

(3) Relationship of document creation to sales process

B. Number of documents and division of issues among them

(1) No standard arrangements on this issue

(2) Importance of being able to find an answer

(3) Effect of location of issue on ease of making changes

C. Usage rights

(1) Needs for transparency, fairness, and permanence

(2) Fixed Usage—pricing effect going in and coming out

(3) Floating usage

A. Unit specific versus multi-unit

B. Fixed rotation versus reservation-based

C. Limitations on length of each usage

D. Computer software-process must be explainable in writing and verifiable

E. Operating cost considerations

D. Rentals

(1) Defining “Rental”

(a) Owner is or is not physically present

(b) Who are “friends and family”

(c) Enforcing “no payment” rules

(d) Defining “rental” based on advertising

(2) Whether or not to allow rentals

(a) Exclusivity versus practicality

(b) Degradation of condition

(3) Requiring non-owners to go through HOA-selected agency

(4) Dealing with rental income/rent pooling

(5) Dealing with rental damage

E. Maintenance/Repairs/Replacement and Assessments

(1) Inventories and reserve funds

(2) Damage or loss caused by an owner or guest

(3) Inability to use due to damage or malfunction

(4) Segregation of funds

(5) Developer responsibility to pay expenses

F. Governance/Control/Decision-Making

(1) Division of power between developer and owners

(a) Developer control periods

(b) Developer voting for unsold interests

(2) HOA Governance

(a) Use of boards, committees and subgroups

(b) Tiered voting; decisions requiring most/all owners

(c) Delegation to manager

(i) Limits of delegation and manager power

(ii) Avoiding too many owner decisions

(iii) Right to dismiss/replace manager

(iv) Bonding and insurance for manager

F. Usage Rules

(1) Arrival and departure

(a) How guests get in

(b) When is property cleaned/inventoried and who pays

(2) Addition/Rearrangement of furnishings and content

(a) Strict restriction essential

(b) Private storage and access to storage

(3) Pets

(a) Deciding whether or not to allow

(b) Types of limitations

(3) Maximum occupancy limits

(4) Smoking

(5) Hazardous transportation or recreational equipment

G. Resale

(1) Developer-oriented restrictions

(a) Timing restrictions/waiting periods

(b) Requirement to sell through developer

(c) Pricing restrictions

(2) Owner-oriented restrictions

(a) What are rights of first refusal and rights of rejection

(b) Typical operation of these rights

(c) Effect on sale process

(c) Effect on "discounted" sales and gifts

H. Lender protection

(1) Need for lender protection provisions

(2) Typical lender protection provisions

I. Blanket Encumbrances

(1) Due on sale clause issues

(2) Group loan versus wraparound financing

(a) Explain terms

(b) Tax treatment

(c) Charging a spread

(3) Managing risk of default

(a) Payment systems

(b) Default reserve funds

(c) Control over admission

(d) Nonpayment and default

(4) Resale and refinancing

(a) Importance of planning for resale/refinancing w/blanket loans

(b) Problems with voting on refinancing

(c) Systems for enabling resale/refinancing

J. Enforcement

(1) Need for process to get offending owner out of group

(2) Legal restrictions of forfeitures

(3) Use of fines/liquidated damages

(4) Foreclosure approaches

IV. FRACTIONAL INTEREST SALE PROCESSES

A. Dealing with marketing and reservation restrictions

B. Serial closing

C. Pre-sale requirements

(1) Connection to loan payoff

(2) Proving viability of project

D. Interim occupancy

E. Partial releasing

V. PROTECTING FRACTIONAL OWNERSHIP INTEREST SELLERS FROM LIABILITY

A. Types of exposure

(1) Timeshare and securities law violations

(2) Construction defects

(3) Fraud/non-disclosure

B. Insurance types and availability

C. Use of legal entities

(1) Limits of protection

(a) Exposures protected

(b) Assets protected

(2) Costs of formation and maintenance of entity

(3) Tax ramifications of entity use