

Strata Titled Hotels - A Popular Investment - Need For A Prospectus?

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The strata-titled hotel is becoming an increasingly popular form of investment for the smaller investor in city and tourist regions. The individual units or rooms are sold to individual investors who place their room in the pool of rooms available for letting by the hotel manager. The hotel manager is almost always known to the investors when they make their decision to buy.

Reasons for Popularity

This form of investment is popular for a number of reasons:

- There is a view that the hotel manager will be able to achieve room occupancy levels and tariffs that are significantly better than the on-site unit managers. This is particularly so in tourist areas where unit managers tend to be able to let holiday units successfully during peak seasons but have difficulty achieving lettings during non-peak periods.
- There is an opportunity to achieve greater capital growth on the basis of the higher and more consistent income stream.
- It is perceived that the negatively geared room is a better tax effective investment than the negatively geared unit in a complex managed by a unit manager.

The developer and the hotel manager are often subsidiaries of the one holding company or alternatively have some joint venture linkage.

The developer considers the strata-titled hotel an attractive opportunity because:

- Funding of the project is able to be secured based on the pre-sale of rooms to investors. The same development proposal structured as an independently owned and operated hotel may not be able to be "sold" to the developer's financiers.
- There is a profit achieved through the sale of the rooms and yet hotel management of the project is retained.
- The project is able to be done without the company's balance sheet carrying the burden or risk of long term debt.

Just a Real Estate Transaction?

Whilst the sale of strata-titled units or rooms is ordinarily a real estate transaction and no more, developers and other parties involved in the marketing sale and acquisition of strata-titled hotels need to carefully consider their project in light of the Corporations Law provisions.

If the sale is one of "securities" within the meaning of the Corporations Law then ordinarily a prospectus is required to be approved by the Australian Securities Commission and delivered to purchasers **before** purchasers commit to buy.

In simple terms, the sale of a strata-titled room will be categorised as the sale of "securities" where the purchaser is said to be participating in a common enterprise and the purchaser is led to expect profits or rent from the efforts of a promoter of the enterprise (the vendor) or a third party (the hotel manager).

The sale of rooms is not a common enterprise merely because many purchasers require rooms from the developer on similar terms. However, where the enterprise is structured so that each of the individual purchasers are entitled to see that all or substantially all of the other purchasers similarly place their room into the pool on similar terms thereby allowing the hotel manager to manage the complex as a "hotel" then there may be said to be a "common enterprise".

General Principles Emerging

Purchasers are often asked as part of the contract documentation to commit their room to the pool of rooms available for letting by the hotel manager. The form of agreement ("the letting agreement") to apply as between the purchaser and the hotel manager is often annexed.

In each of these instances there is potential for the sale to be categorised as the sale of securities. A number of general principles are emerging:

- Where the letting agreement is no more than a

standard agency agreement which the purchasers might be asked to sign by any real estate agent then it is unlikely the sale will be of “securities”.

- Where the letting agreement has the effect of placing the room in the control of the hotel manager and the purchaser’s entitlement is to share a fixed proportion of an overall profit from the operation of the whole complex as a hotel then the sale is one of securities. Profit is in this instance calculated by deducting expenses of the operation (including the agreed hotel manager’s remuneration) from the total room and other income of the hotel operation.
- Where the letting agreement has the effect of placing the room in the control of the hotel manager and the purchaser is entitled to a return based on the occupancy achieved from the letting of the purchaser’s room then the position is less clear.

It is a term (express or implied) of the purchaser’s contract that all or substantially all purchasers of rooms will enter into the letting agreement with the hotel manager. The letting manager sets tariffs and determines to whom and for how long the room is let. Rooms in the pool are, so far as possible, let on a rotational basis to ensure the rooms have similar occupancy rates. Then although there is no pooling of income, there is a real danger the sale is of “securities”.

- Where the agreement is by way of lease back and the rental is fixed (ie not a reflection of profit of the “hotel”) then the sale is not likely to be “securities”.

Effect of Non-Compliance

The question of whether the sale is of “securities” is critical because where there is a sale of securities and no approved prospectus is delivered then purchasers have a statutory right to withdraw from their obligations to buy. Promoters are liable to fines and claims for damages.

Summary

The Corporations Law needs to be considered when marketing and selling rooms in a strata-titled hotel and in many cases it will be appropriate and necessary for a prospectus to be approved and delivered. The developer and hotel manager need to assess the nature of their product and ought err on the side of caution and have a prospectus approved where the Corporations Law is likely to apply.

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