



## legal structure and ownership of a timeshare project

by John Rogers Burk, Esq.

There is still much confusion in the timeshare industry, even among legal professionals, as to the substance, effects, and distinctions among three separate aspects of timesharing:

- The substance of the timeshare plan and property, consisting of the legal structure of the plan and ownership or control of the property (collectively, “Project”);
- Establishment of consumer membership/ownership relationship with the Project (“Conveyance”); and
- Features of the Project—such as points—that don’t affect its substance (“Features”).

For this article, the bundle of rights, benefits, burdens, and duties (collectively, “ownership” or “membership”) that a timeshare owner/member has in a Project is referred to as a “timeshare interest” (“TSI”). The substance and essence of a TSI has basic elements (see the sidebar on p. 50 for the Features a TSI might have):

- Overnight use of living accommodations,
- A specified or measurable number of nights each year or other period,
- Permanently or for a specified number of years,
- An initial purchase price, or
- Subject to payment of an annual assessment for operation and maintenance.

TSIs can be established in different ways, in different kinds of property, and with a variety of Features; they can also be conveyed by different methods. The method by which they are conveyed, however, does not add to or detract from the substance of the TSI or the Project. The extent of control and responsibility over the Project by the owners/members, not the means of Conveyance, determines whether a consumer is an “owner” or merely a member with use rights. This arti-

cle assumes that the individual owners who purchase a TSI control the Project through their voting power.

This article also assumes real property dedicated to a timeshare plan with fixed accommodations suitable for overnight occupancy. However, many of the same principles would be applicable to a timeshare plan in movable accommodations, such as cruise ships or recreational vehicles.

### DECLARATION

The substance, foundation, and basis for timeshare Projects is normally a declaration that is recorded in the local real property records against the real property that is the subject of the timeshare plan.

The declaration normally provides for

- Rights of use and occupancy in the accommodations and common area by the timeshare plan owners;
- The duration of annual use rights or how that is determined;
- How someone becomes an owner in the timeshare plan;
- What constitutes ownership in the timeshare plan;
- An association of the owners;
- Procedures for operating the association (although most operating procedures would be contained in the unrecorded bylaws of the association);
- Protections for the rights and interests of the owners;
- Control by the owners;
- Obligations of the owners, especially the payment of an assessment for operations, maintenance, and reserves; and
- Amendments.

The declaration should be signed and acknowledged by all holders of record title to the real property and by all holders of any encumbrances that could materially affect the rights of individually owned TSIs. It should constitute covenants run-

Title Deeds

ning with the land and equitable servitudes, so as to be binding on all future holders of any interest in the real property.

## TITLE TO REAL PROPERTY

After the declaration is validly executed and recorded, it probably doesn't matter who or what holds record title to the real property because the real property will be subject to the timeshare plan and controlled as provided in the Declaration. However, early abuses or failures where the developer held title and/or title was not effectively protected have led to overly burdensome, inefficient regulatory protections in and confusion about the manner of holding title.

### *Titleholders*

"Title" may be held in the name of numerous individuals, one individual, an entity, or a trustee.

### *Ownership*

"Ownership," on the other hand, is the bundle of rights and obligations pertaining to the property, which may or may not be held by the holder(s) of title. A material misperception throughout the timeshare industry and the regulatory environment is that title and ownership are synonymous. For example, an entity, sometimes called a "special purpose entity" ("SPE") may hold title, but the benefits and burdens of ownership belong to the voting members of the entity under the Declaration and other governing documents. Or a trustee may hold title to property, but the real ownership (benefits and burdens) belongs to the beneficiaries of the trust who should be the individual TSI owners—depending on the terms and interrelationship of the Declaration and the trust instrument.

Attorney Richard F. Davis of Greenberg Traurig, LLP, gave an excellent presentation at the 2004 ARDA Convention "Ask the Attorneys" session, in which he made the case that if the benefits and burdens are the same, a "non-deeded" Project where an SPE holds title for its voting members is the "functional equivalent" of a "deeded" Project where individual deeds are issued and recorded for each TSI owner.

### *Encumbrances*

Title to real property is usually subject to encumbrances that affect "ownership." For example, homeowners who hold title subject to a large mortgage frequently quip that the bank *owns* the house. If an encumbrance is substantial, like a timeshare declaration, it actually establishes



and defines "ownership."

Encumbrances include:

- Tax liens, due or not yet due;
- Easements;
- Monetary encumbrances (such as mortgages or deeds of trust, usually for the repayment of the purchase price or construction financing); and
- A declaration for timeshare property, as described earlier.

Encumbrances are listed in a preliminary report of title or title policy or commitment as exceptions, which means the title company will not insure against those items. Any encumbrance that could materially affect a TSI without the consent or acquiescence of non-defaulting TSI owner should be subordinated to the declaration. Law or regulation usually requires this—and if there are no laws, ethics and honest business practices require it.

## CONVEYANCE OF TSI

There is some misperception in the industry and the regulatory environment that the means of Conveyance of the TSI affects the substance and treatment of the TSI. But the declaration, some features, and the provisions of the Conveyance (not the form of the Conveyance) all determine the substance of the Project and the TSI.

Sixteen years of very successful experience in the marketplace has shown that there is no difference in treatment based on the manner of Conveyance, if the substance of the TSI is the same on the following matters (all of which are discussed later):

- Income taxation,
- Accounting,
- Sales,

- Financing,
- Securities regulation,
- Bankruptcy, and
- Features (see sidebar, p. 50).

Here are the three most common methods of Conveyance and holding title in a timeshare plan.

### *Individually Deeded*

Due to the discomfort of lenders and regulators in the early years and the comfort level of attorneys and land developers, the most common form of conveying TSIs was (and still is) to convey undivided interests in real property by grant or warranty deed to each timeshare owner. This is often referred to as "deeded fee timesharing," but this kind of "ownership in a [timeshare project] is so encumbered with requirements and restrictions that it borders on fiction" (John R. Burk, *Developments*, April-May 1995).

One of the first things I learned in law school was that a deed is only *evidence* of ownership. Using a deed to convey a TSI includes several disadvantages that are unnecessary and unsuitable. Here are some of them:

- Direct personal liability of the individual TSI owner for uninsured injuries or environmental clean up (if this ever surfaces, it could be devastating to the developer and regulators who failed to disclose the possibility, especially when there was an easy and safer alternative);
- Much greater foreclosure delays and costs ("The administrative problems are what seem to have driven a company like Glen Ivy out of business, and that was the foreclosure costs, delays, and legal necessities, and the [non-deeded] doesn't carry with it all those complica-

## FEATURES OF A TIMESHARE INTEREST

In addition to the basic elements or substance of a timeshare interest (TSI), there are various Features. These do not depend on the underlying legal structure of the time-share Project or upon the manner of Conveyance of the TSI but may affect the tax and accounting issues.

**Term.** The TSI may last for a term of years or be permanent/perpetual. However, a term less than perpetual must be accounted for as a lease rather than a sale under the AICPA Accounting Standards for Real Estate Timeshare Projects. It is also a timeshare use under the new California Vacation Ownership and Timeshare Act of 2004 (B&P Code § 11212(x)(2)).

**Flexibility/Points.** Most early Projects were in the form of fixed unit and fixed week, usually conveyed by a deed, which designated a 1/51 or 1/52 (depending on the regulatory requirement) undivided interest in a particular condominium unit in the Project and a particular week, such as the third week of August each year. Flexibility of reservation opportunities was gradually increased, due to consumer demand. Some current Projects provide memberships denominated in points (just a *measure* of membership),\* which can be purchased in any amount above the prescribed minimum and used in varying amounts for accommodations, depending on the day(s) of the week, season, size of the unit, location, and/or the relative demand. A points program eliminates the marketing problem of having to sell weeks during the undesirable seasons or at less desirable Projects but also includes greater complexity of administration and inventory control.

**Reservations.** Even in a fixed-week, fixed-unit Project, an owner's week often must be reserved at least a short time in advance or it will be made available to other members or renters. The variation of reservation programs is endless. Usually reservations more than 2 or 3 months in advance must be for an entire week; shorter term reservations may be for as little as two or three days. There may be limits on the number or type of reservations that can be held at one time; reservations for weekends and/or holidays usually have more limits than normal weekdays.

**Home Resort.** An owner may be able to designate a home resort in a multi-site Project. This can be based on where the owner's deed is recorded or designated in the membership agreement. There is usually a reservation priority for the home resort. California now requires a 90-day reservation priority if a home resort is to be registered as a single site with component sites where there are reservation rights of lower priority.

**Bonus Time.** Some Projects allow owners to reserve occupancy in addition to that allowed by their TSI—usually with a very short reservation window (i.e., 14 days), upon payment of a daily fee, and only if space is available.

**Borrowing/Carry Over.** Owners may be allowed to borrow TSI time from the next year or carry forward unused TSI time to the following year. There may be conditions such as advance written notice, payment of the association assessment for the following year, and/or no existing default.

\* Remember: Points are merely a measure of membership.

- tions.” [Stuart Bloch, *Developments*; April-May 1997, p. 58];
- Foreign probate when an out-of-state owner dies (this is a major issue pending in Florida, where a probate attorney recently administered a timeshare week for an out-of-state decedent for \$3,000);
  - Clearing title upon condemnation, sale, or substituting another resort or unit;
  - Individual assessment of property taxes if delinquencies are not kept under control;
  - Delays in recording/closing the sale;
  - False sense of ownership if the declaration contains powers in the developer that are inconsistent with normal owner rights and powers;
  - Multiplicity of documents (6 to 30, as compared to two for an SPE offering);
  - Higher transaction costs over the SPE structure;
  - Materially greater burden and cost to the association for transfers and foreclosures forever (unless the association converts the TSIs to an SPE structure);
  - Real Estate Settlement Procedures Act (RESPA) compliance; and
  - Not compatible with most foreign jurisdictions.

### *Special Purpose Entity (“SPE”)*

This is commonly referred to as “non-deeded” ownership. The developer may convey fee title or lease to an independent entity, usually a nonprofit corporation, which is also the association of timeshare owners. The developer then has the right to sell voting memberships in the SPE. The owners control the SPE through their votes for the Board of Directors or amendment of the declaration and on all major decisions, such as sale or encumbrance of the Project. The owners therefore control the real property the SPE holds title to in *exactly* the same ways “deeded” owners or lessees control their real property. Remember, *it is the declaration* that establishes the protections, benefits, and burdens of ownership, not the manner of Conveyance. The advantages of the SPE legal structure are the exact opposite of the disadvantages just listed above.

The disadvantages of the SPE structure are as follows:

- There are still misperceptions in the regulatory environment that don't treat deeded and non-deeded TSIs the same way as in sales tax or transient occupancy tax regulations. But so far, regulators have favorably responded to being educated on the true nature and substance



of the TSI in question.

- Deed-oriented sales personnel will need to be re-trained.
- The security interest in financed sales will need to retain its perfection if the purchaser changes state of residence (see “Financing” section on p. 52).

#### Trust

One of the legal structures accepted by regulators in the early days to avoid the complexities and disadvantages of deeds or leases to individual purchasers was the

bureaucracy must be established—the member association and the trustee’s responsibilities beneficiaries’ benefits at the trust level—with a solid interrelationship. The mix of burdens and responsibilities can vary greatly. The worst consequence of the trust scheme over the years has been the difficulty of clearing title when the title-holding trustee has disappeared or merged several times.

In essence, there seems to be little practical effect and no additional protection added with the use of a trust. In fairness,

individual TSI owners by individual deeds or to an SPE or trust by one deed. “Non-reversionary” means that the title is not projected to come back to the developer. Transfer of title (to individuals or an SPE) with a reversion in the developer should be accounted for as a lease, whether the Conveyance document is an entitled “deed” or membership agreement. The AICPA has defined “right to use” as any legal structure in which the developer does not convey non-reversionary title.

#### TAXES

There is still widespread misunderstanding, even in the legal community, that the form of Conveyance affects the tax treatment of the transaction. If the basic elements are the same, the substance of the TSI is the same, whether the TSI is conveyed in the format of a (1) individual grant or warranty deed, (2) membership agreement in an SPE that holds title to the property, or (3) beneficial interest in a trust that holds title to the property.

Laws for two or more decades have treated deeded and non-deeded TSIs similarly. Here are a few examples:

- Installment sales reporting for income tax purposes (IRC §453);
- Deduction of second home mortgage interest (IRC §163 and Regulation 1.163-10T(p)(6)); and
- Windrifter—IRS Letter Ruling No. 7803005 (September 30, 1977) has almost universally been misconstrued by attorneys for over 30 years. The result was based on two factors: (a) The Windrifter membership was for a *term of years* rather than perpetual, and (b) the *benefits and burdens* of ownership were *not transferred* to the members. The manner of Conveyance is entirely irrelevant to a Windrifter analysis.

Two false Windrifter conclusions recently expressed by attorneys in public presentations were

**False:** “We don’t have a Windrifter problem because we convey an interest in real property.” (The membership in Windrifter was construed to be a lease.)

**False:** “Windrifter requires that the entire purchase price of the membership be recognized as income in the year of sale, even if only a 10-percent down payment is received.” (The Windrifter Ruling states in the discussion and the conclusion that the sales proceeds [rent] are recognized as taxable income *when received*, which is normal income tax treatment for lease proceeds. In Windrifter, the entire sales proceeds happened to be received in the year of sale.)

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transfer of title to the property to a trustee, subject to a trust instrument. Some offerings then issued term memberships, which varied in their ranges of control by the owners. Some regulatory schemes still require the trust mechanism if individual deeds are not used but have recognized and accepted the validity and protections of the SPE structure described in the section above—especially in California, Hawaii, Nevada, and Florida.

However, the trust mechanism provides an entirely unnecessary level of complexity and bureaucracy without any improvement in protection over the much more simple SPE mechanism. Two levels of

a trust titleholder may be useful for short-term TSIs, where control of the real property is not to be given to the timeshare holders but protection of the real property is necessary. Even this, however, could be covered by a declaration with an expiration date and a term membership.

#### ACCOUNTING

The American Institute of Certified Public Accountants (AICPA) has developed Accounting Standards for Real Estate Timeshare Projects. For financial accounting purposes, a transaction will be treated as a “sale” if the developer transfers non-reversionary title, whether to the

## **BANKRUPTCY**

The bankruptcy proceeding for Epic Resorts, LLC, Case No. 01-2458, Bankruptcy Court for the District of Delaware, establishes that a properly structured SPE is protected from the bankruptcy of the developer. The U.S. Bankruptcy Code (11USC, § 101(49) and §365(h) and (i)) treats deeded, right to use, and SPE TSIs similarly.

## **FINANCING**

Since designing the legal structure for Trendwest Resorts/WorldMark The Club in 1989, the author has been closely involved in obtaining receivables financing and securitization for non-deeded offerings of timeshare memberships with Greyhound/Finova, Textron, and Prudential Securities. Michael J. Smith, RRP, of Wells Fargo Foothill said,

The structure between clubs and deeded products is essentially the same today. That wasn't always the case. The lenders have become more sophisticated and had a lot of their questions answered. There's a different appetite today. What's really driving terms today is the risk pro-

file of the transaction itself, and it's not really driven at all by product type. . . .On the receivable side...what's really driving advance rates on paper right now is not whether it's a deeded product, a club product, or a points product, it's really what information the lenders have been able to review from the developer's prior portfolio performance. (audiotape of Advanced Timeshare Finance Workshop, presented at 2005 ARDA Convention, Orlando, April 2005)

The challenge for a secured credit seller or lender is to assure continued perfection of its security interest in a non-deeded TSI, a general intangible under the Uniform Commercial Code. The following are suggested and have been implemented: (1) the security interest in the TSI is perfected by filing a UCC1 Financing Statement in the state of the purchaser's residence; (2) notice of the lien on the TSI should be printed on the Certificate of TSI/Membership; and (3) the club or member association should control all transfers through an independent licensed,

bonded escrow company and not allow transfers with lender liens without a release of the lien.

## **CONCLUSION**

Most timeshare projects build in unnecessary costs, burdens, and risks at the developer, lender, sales, association, and consumer levels. This is done by using a centuries-old form of Conveyance that arose in feudal times and has much application in whole ownership (but has many unintended detrimental side effects in fractional and timeshare ownership), and also by not recognizing that the substance of a timeshare project is not in the form of the Conveyance, but is in the Declaration with its protections and assignment of benefits and burdens. **D**

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