

# CONTRACTION OF CONDOMINIUM PROJECTS

By David W. MacDonald

## Introduction

In today's market, with real estate sales down and with financing being more difficult to obtain, real estate developers of residential condominium projects are looking to reduce the size of their existing condominium projects. Two of the most common reasons for doing so include the cost of maintaining a condominium project that is largely vacant, and the inability for the condominium project and the proposed purchasers of a unit in the project to qualify for FHA financing.

A condominium project that has many unsold units may have many of the same costs as a completely sold condominium project. For example, the general liability insurance to insure for injuries to persons occurring on the common elements of the condominium project which typically include the roadways, walkways, parking areas, and other areas which are for the benefit and use of all unit owners, and sometimes the driveways and lawn areas, is usually going to be the same regardless of the number of units that have been completed and sold. Also, the landscaping costs of the entranceways and other completed and landscaped common areas of the condominium project and the snow removal costs for the roadways will be the same regardless of the number of units completed and sold. All of these costs are shared by the unit owners based on their percentage ownership of the condominium project and if a substantial number of units of the condominium project have not been sold, then the developer who still owns a substantial portion of the condominium project may be required to pay the deficiency amounts to cover such costs. By removing some of the land from the condominium project, the developer may be able to reduce his overall costs since some of the responsibilities the developer has with respect to the land while it is part of the condominium project, or the costs related thereto, may be less when the land is not part of the condominium project.<sup>1</sup>

Also, in order to qualify for FHA financing for the purchase of a unit in a condominium project, the condominium project needs to qualify for FHA financing. As of October 1, 2009, one of the requirements for the condominium project to qualify for FHA financing is that at least 50 percent of the units in the condominium project are owner occupied.<sup>2</sup> FHA financing has been one of the more common avenues of late to obtain financing to purchase a residence. FHA financing allows a low down payment which opens the door to more purchasers. However, developers that have condominium projects in which less than 50 percent of the units have been sold lose the market of purchasers who are seeking FHA financing.

For these reasons, many developers who developed large residential condominium projects, and who have been unable to sell units due to the current residential market, have now been seeking to reduce the size of their condominium projects in an effort to reduce their annual maintenance costs and in order to stimulate sales through FHA financing. This article will focus on the issues to be concerned with when reducing the size of a condominium project and/or the number of units in a condominium project.

## **Master Deed Review**

In order to reduce the size of a condominium project, a developer may be able to remove some of the land and all units and common elements included on such portion of the land from the condominium project, which process is known as a contraction. However, the master deed of the condominium project will need to contain specific language required by the Michigan Condominium Act permitting the condominium project to be contracted.<sup>3</sup> Also, the contraction will need to take place within 6 years of the date that the original master deed was recorded for the condominium project. If either of these two criteria are not met, then the condominium project cannot be contracted. However, there may be some other things that can be done to help the developer obtain FHA financing. For example, the developer might be able to convert a certain number of unsold units of the condominium project into common elements. A conversion, like a contraction, however, will require specific language in the master deed of the condominium project permitting such a conversion and the conversion will need to take place within 6 years of the date the original master deed for the condominium project was recorded.<sup>4</sup> It should be noted, however, that a conversion of unsold units to general common elements may occur automatically if there are unsold units in the condominium project after 10 years from the date of commencement of construction by the developer of the condominium project.<sup>5</sup>

## **Land Division Issues**

Assuming that either or both options of contracting or converting the condominium project are available because the master deed permits such actions and the condominium project is less than 6 years old, then the developer will need to consider other issues that can affect the ability to contract or convert. With respect to the contraction of the condominium project, the developer will need to verify that the portion of the condominium project that the developer wishes to remove from the condominium project qualifies for a land split. The developer will need to review such contraction with the local assessor to determine whether the proposed land split meets all applicable legal requirements of the Michigan Land Division Act and the requirements of the local municipality.<sup>6</sup>

## **Real Estate Tax Issues**

In the event that the developer desires to convert a portion of the condominium project, then the developer will also want to review such conversion with the local assessor in order to make sure that there will not be any negative real estate tax consequences to either the developer or the existing unit owners as a result of the conversion. In either case, the master deed will need to be amended to permit the contraction or conversion and in each case, the developer will need to pay any outstanding real estate taxes on the unsold units before the amendment can be recorded.<sup>7</sup>

### **Third Party Consents and Ancillary Document Restrictions**

In the event the condominium project is subject to a development loan from a third party lender, the developer will need to review its loan documents to verify that the loan documents do not prohibit the contraction or conversion of the condominium project. Also, the developer will need to review all consent judgments, restrictions, site plan and other governmental approvals, applicable ordinances and regulations, and any agreements entered into with any party related to the development of the project to verify that such consent judgments, restrictions, site plans, governmental approvals, ordinances, regulations and agreements do not prohibit the proposed reduction in the size of the condominium project and/or the number of units in the condominium project. The condominium documents will also need to be reviewed to verify that the consent of the existing co-owners or any mortgagees is not required in order to contract or convert a portion of the condominium project. Otherwise, the developer will need to obtain such consents.

### **Marketing**

Reducing the size of the condominium project may increase or decrease the association dues to be paid by the existing co-owners. Although the costs to maintain the condominium project may decrease by reducing the size of the condominium project, there may be fewer owners to pay for such costs if the number of units is reduced. The developer may want to avoid the association dues from increasing as a result of the reduced number of units in the condominium project in order to attract new purchasers and sell more units in the condominium project.

### **Control**

In the situation where the number of units in the condominium project is reduced, the developer may want to review the master deed for the condominium project and the Michigan Condominium Act to verify that the developer still owns enough units to control the board of directors of the association.<sup>8</sup>

### **Conclusion**

With today's current residential real estate market, developers of residential condominium projects are looking for ways to save costs and stimulate sales of condominium units. Some developers are considering reducing the size of their condominium projects in order to save costs and/or stimulate sales. However, in doing so, developers will need to review the condominium documents, loan documents and other agreements, restrictions, governmental approvals, local ordinances and/or consent judgments related to the development of the condominium project to determine if reducing the project size or the number of units in the condominium project will be permitted. The developers will also need to verify with the local municipality for the condominium project that the reduction of the condominium project will not create any real estate tax problems for the developer or existing unit owners and that any project contraction will be in compliance with any applicable land division laws.

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- <sup>1</sup> For example, the developer might not have the responsibility to maintain the roadways or other common elements removed from the condominium project.
- <sup>2</sup> See Mortgagee Letter 2009-19 dated June 12, 2009 issued by the U.S. Department of Housing and Urban Development; prior to October 1, 2009, at least 51% of the units in the project had to be owner occupied in order to qualify for FHA financing. See 24 CFR 234.26(e)(3). It should be noted that the purpose of this article is not to discuss the requirements for FHA financing and this article does not discuss all requirements for obtaining FHA financing for a condominium project.
- <sup>3</sup> MCL §559.133.
- <sup>4</sup> MCL §559.131 and 559.141. The developer may also want to review the master deed to determine if upon a contraction or conversion, the developer can later add units back to the project if desired. There may be limitations on doing this if the condominium project becomes an FHA approved condominium project.
- <sup>5</sup> See MCL §559.167(3); the ten year time period assumes that the developer has not contracted, expanded, or converted any portion of the condominium project prior thereto.
- <sup>6</sup> MCL §560.101 et seq.
- <sup>7</sup> MCL §211.135.
- <sup>8</sup> See MCL §559.152

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