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Condo Conversions

Three Issues for Owners and Lawyers to Consider

Commercial condominiums are being implemented with increasing frequency in structuring real estate transactions. The condominium form has made ownership viable for and accessible to a wider variety of parties, especially occupants who typically lease space rather than own. The advantages of condominium ownership include:

- The owner has greater long-term certainty and control of property costs, operating expenses and availability;
- The owner has greater freedom over the use and ultimate disposition of its property;
- A condominium unit is significantly easier to finance than a leasehold due in part to the absence of termination risk and the subdivision of the unit into a separate tax lot;
- The owner benefits from increases in property value;
- The owner may avail itself of tax advantages such as depreciation deductions; and
- Condominium ownership makes particular sense for a not-for-profit user, as ownership allows the user to obtain a real property tax exemption.

While benefits of the condominium form are apparent, integration of disparate uses and ownership, coupled with the need to create a regime that will effectively function over time, create numerous issues in execution. Many issues boil down to the tension between allowing each owner freely to use its property and conduct its business, and preventing negative externalities that harm the other owners.

Cost Allocations

Each condominium owner is responsible for expenses relating to its unit and an allocable share of the condominium expenses.

The most straightforward manner of allocating costs is based on the owner's common interest in the condominium.

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COMMERCIAL CONDOMINIUMS



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Common interest is a term that refers to each owner's undivided, fractional interest in the common elements of the condominium (i.e., areas of the property, such as the land, structural elements, lobbies, ventilation shafts, etc., that are not included within any unit).

Section 339-i of the Condominium Act permits considerable flexibility in determining each owner's common interest. The prevalent manner of fixing common interest is based on gross square footage of each unit, or some variation of gross square footage (for example, applying a discount to the gross square footage of a less valuable portion of the improvements or one that generates a smaller per square foot portion of the expenses).

The division of costs based strictly on common interest has become the exception rather than the rule. Especially in condominiums with disparate uses, owners have realized that certain costs are not generated in proportion to common interest and should not be shared on that basis.

Certain costs lend themselves to a common interest allocation because allocating based on unit size seems the fairest and least subjective method. For example, the cost of maintaining and insuring the "core and shell" is typically passed along to the owners in proportion to their common interest.

For other expenses, allocation in proportion to common interest would be plainly inequitable (and would lead to inefficiencies), and in such cases an allocation based on usage may be preferable. For example, the use of a

loading dock may bear no relation to common interest, especially in a mixed use condominium; a retail or hotel use would likely make far greater use of the loading dock than an office use. Other examples of costs that lend themselves to allocation by usage include freight elevator costs and shared interior public space.

Allocation of costs based on usage usually has the effect of complicating negotiations. Each owner will have an agenda as to which costs should be allocated based on usage, and each owner will typically have different conceptions of how much of a given service it actually uses. The number of times and the aggregate amount of time that each owner uses a loading dock can easily be measured. Other costs, such as elevator costs, can be divided using a modified usage concept based on the relative number of floors of each unit serviced by the elevator.

Issues come up, however, when it is more difficult or impracticable to measure actual or allocated usage, such as building security services. Building security is often more for the benefit of certain owners, such as ground floor retail, and thus allocation by common interest is not favored, but a usage concept is really inapposite. In such a case, the parties need to agree on a fair allocation based on relative benefit, which is quite subjective and consequently sometimes difficult to resolve.

Another issue when allocating by usage, which has arisen in the case of HVAC cost allocations, is whether to allocate based on the actual usage of each owner or the HVAC capacity of each owner. There is no right or wrong resolution of these issues, and it is a matter of an often long, drawn out negotiation.

An unintended consequence of usage allocation is that it makes administration of the condominium much more difficult. Often, costs arguably may fall within more than one category, which can lead to disputes. For example, property management costs will likely relate to exterior space, core and shell, shared interior space, the HVAC plant and the loading dock, all of which may have different methods of cost allocation.

Moreover, as the allocation scheme becomes more detailed, the administrative burden of implementation on a periodic basis increases. While the putative accuracy of usage-based allocation is tempting, owners should consider administrative issues before going down this path.

Some owners have a preference for minimizing all that is common, to limit reliance on third parties of unknown creditworthiness for payment of operating expenses. The physical improvements and building systems may be designed in a manner that maximizes separation and therefore minimizes common expenses. For example, each unit can be designed to have separate elevators, separate HVAC systems and the like.

The success in accomplishing this goal may depend on the practicalities of the building design, such as availability of space. Separation may create inefficiencies by increasing capital costs and eliminating economies of scale. Nevertheless, for some owners, these inefficiencies are a small price to pay for the peace of mind that results from separation.

Voting Rights

In the most elementary condominium documents, voting rights with respect to the board of managers are in accordance with common interest. As the complexity of condominium documents has increased, so has the allocation of voting rights.

As a general rule, the voting rights of each party with respect to a particular decision should be roughly proportional to the interest of each party in that decision. When cost allocations do not mirror common interest, the decision of the board of managers to incur a particular cost should be made with reference to the proportion of such cost that each party bears, although under certain circumstances there may be countervailing arguments why a cost must be incurred for the benefit of the building as a whole.

Whether voting rights are allocated based on common interest, cost allocation or any other method, it is important to protect minority unit owners from the "tyranny of the majority." These protections tend to differ depending on whether the condominium has only two unit owners, multiple unit owners none of which holds a majority, or multiple unit owners, one of which holds a majority.

In a two-unit condominium where one owner holds a majority (but not a substantial majority), the most equitable method of allocating voting rights is to require unanimous consent for all condominium decisions, as any other result completely disenfranchises the minority owner.

In the event the parties cannot agree on a

decision, an arbitration mechanism or some other dispute-resolution procedure (e.g., using the prior year's budget with an inflation mechanism) should be invoked.

In a condominium with several owners, none of which holds a majority, a majority vote, or supermajority vote for certain major decisions (e.g., modifying insurance requirements), is customary.

In a condominium with several owners one of which holds a majority, unanimity should not be required, but something more than a simple majority is needed in order to protect the minority owners from being disenfranchised. Such protection may be achieved using supermajority voting, or a "majority-plus-one" technique whereby a decision that could otherwise be made with the input of only one owner would require at least one minority owner's concurrence.

Under any condominium structure, certain decisions are of an importance that requires unanimous consent, such as substantive amendments of the condominium declaration or the bylaws and changes in use restrictions. Other decisions, such as advertising, marketing and promotional expenditures, often require unanimous consent of the owners under the rationale that these expenditures should be left to the individual unit owner unless it is in the interest of all owners to make them collectively.

Use Restrictions

Use restrictions are a common feature of condominium declarations. While each owner may seek to maximize its freedom to use its unit in any lawful manner, each owner also has an interest in minimizing negative externalities arising from the use of the other units, which may relate to offensive or noxious uses or uses in competition with other unit owners. The perception of offensive or noxious uses is somewhat subjective.

Common practice in condominium declarations has evolved a fairly standard set of prohibited uses, such as going-out-of-business sales; illegal, immoral or pornographic uses; nuisance-type restrictions on restaurant uses; and other similar restrictions.

Uses that bring substantial numbers of visitors to the building, such as retail or movie theatre uses, may be restricted in their hours of operation, especially when one of the other principal uses in the condominium is residential.

Certain owners may have particular concerns based on their organizational purpose or intended use. For example, an owner providing health care services may seek to prohibit the sale of tobacco products anywhere on the condominium premises; similarly, a church may seek to prohibit genetic engineering or

family planning services in the building.

Another common source of use restrictions is competitive concerns. A hotel owner would usually seek to restrict the conversion of another unit into a competing hotel for obvious reasons. An owner using an office condominium as its headquarters would be loathe to permit its chief competitor from opening a retail store in the building. A retail condominium owner may seek to restrict the sale of competing products in another unit used as a hotel or other non-retail use.

Use restrictions can be a double-edged sword and must be used judiciously, as they can eventually haunt their proponents. Once a use restriction is included in the declaration, it is very difficult to remove, as only the affected party will have any incentive to relax the restriction, creating tremendous leverage in the other owners.

Use restrictions responsive to the peculiar concerns of an owner at the outset, as with the church example above, may be mitigated by providing for survival only so long as such owner continues to own its unit. In addition, a weaker but less restrictive approach to use prohibitions is to provide for a right of first refusal or purchase option (in favor of the board of managers or one or more owners) triggered by a change in use in violation of the use restriction.

If the right of first refusal or purchase option is not exercised, the owner of the applicable unit would be free to sell or use its unit for the non-conforming use. The magnitude of purchasing another unit makes this remedy of questionable value under many circumstances.

Conclusion

The issues discussed above are perhaps three of the most significant involved in documenting a commercial condominium, but there are many others beyond the scope of this article, among them allocation of rooftop space (which has become much more valuable given telecommunications advances), insurance issues, building naming rights and a plethora of others.

These issues must carefully be considered at the outset, especially given that a condominium declaration is a 'living document' that must be viable for the life of the condominium. The benefits to the owners of a commercial condominium make it well worth the exercise.

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