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## **Advising Prospective Owners of Troubled Condominium Projects**

The condominium market was one of the earliest casualties of the current recession. Poor sales have forced developers of newly built condominium projects into foreclosure, receivership, and distress sales.<sup>1</sup> Often, the developer's inventory of unsold units ends up in the hands of a single owner. This owner might be the developer's mortgagee who acquires the units in bulk through foreclosure or a real estate investor who buys the units in bulk from the developer or from the developer's mortgagee.

This article addresses the key legal issues that arise when representing a client who is acquiring the developer's inventory of unsold units through purchase, foreclosure, or otherwise. In this article, this client is referred to as the "new owner." Prior purchasers of units directly from the developer – usually, owner occupants – are referred to as "resident owners."

### **Statutory Declarant Rights and Obligations**

Special rights granted to the declarant. The Wisconsin Condominium Act refers to the original developer of the condominium as the declarant.<sup>2</sup> The Act gives the declarant special rights to control the key aspects of the condominium's development. These include the rights to expand the condominium (if the condominium was originally designed to be expandable), appoint and remove officers of the condominium association, and appoint and remove a majority of members of the association's board of directors. These special rights last no later than the 30th day after 75 percent of the common-element interest has been conveyed to purchasers. In the typical distressed-condominium situation, the declarant loses its units before reaching the 75 percent threshold.<sup>3</sup>

*Common elements* are the portions of the condominium other than the units: the building housing the units, the common driveways and parking areas, the landscaping, and so forth. In a condominium, every owner of a unit also owns an undivided percentage interest, as tenant in common, in the common elements. If all units have an equal percentage interest in the common elements, conveyance of "75 percent of the common-element interest" means the same thing as conveyance of "75 percent of the condominium's units."

The condominium documents may grant additional rights to the declarant, such as the rights to conduct promotional and sales activities, continue construction on unsold units, build new units and common elements, and pay reduced assessments.

Special obligations imposed on the declarant. The Act imposes several obligations on the declarant. These include the duties to provide prospective purchasers with disclosure documents in a prescribed form, keep association records, and obtain releases of underlying mortgages as units are conveyed. Wis. Stat. section 703.25(1) permits bringing against the declarant a tort action based on a wrong allegedly committed by any agent or employee of the declarant, or in connection with the condition of any portion of a condominium that the declarant has the responsibility to maintain. Section 703.25(2) permits bringing against the declarant an action arising from a contract made by or on behalf of the association if the cause of action arose during the period of declarant control of the association.

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October 29, 2009

MADISON MARRIOTT WEST  
1313 JOHN Q. HAMMONS DRIVE  
MADISON, WI 53562

Walk-ins welcome, admission on  
day of event is \$129

7:30 a.m. - **Registration &  
Continental Breakfast**

7:55 a.m. - 12:00 p.m. - **Program**

The morning conference will feature panelists from Reinhart, Dane County Title Company, WIPFLI, several banks and other organizations that know the important aspects of dealing with distressed real estate.

Reinhart attorneys [Jesse Ishikawa](#) and [Bryan Nowicki](#) will present "Legal Strategies and Consideration for Distressed and Foreclosed Projects" at the Madison Distressed & Invest Real Estate Summit. [Harvey Temkin](#) will moderate two panels and serve as the event emcee.

Verifying that special declarant rights still exist. Under section 703.015(2)(c), the special declarant rights may expire by passage of time or by conveyance of 75 percent of the common-element interest. Thus, the lawyer representing a new owner who seeks to acquire the special declarant rights should verify that those rights still exist.

Assignment of declarant rights and obligations. Under sections 703.02(7) and 703.09(4), the declarant may assign its special statutory rights to a new owner but only if it assigns not less than all its statutory rights and obligations as declarant.

Before taking the assignment, the new owner should weigh the benefit of acquiring the special declarant rights against the burden of assuming the special declarant liabilities. The Act does not let the new owner take the rights without the obligations. If the condominium suffers from faulty construction, poor maintenance, lack of reserves, financial irregularities, or lack of funds, the new owner may decide that the benefits of owning the declarant rights are outweighed by the burdens of the declarant obligations.

The resident owners who have suffered through the condominium's downward slide may view the new owner as the savior of the condominium. The resident owners may expect the new owner to correct construction defects, invest new money, and restore the association's financial position. If the new owner assumes the declarant rights and obligations, these expectations may be justified. If the new owner has not assumed the declarant rights and obligations, these expectations are unjustified, and the new owner would be wise to dampen those expectations before acquiring the declarant's inventory of units.

### **Unbuilt Units**

The new owner may have bought units that exist legally but not physically. This happens when the condominium declaration and plat create units within buildings that have not been constructed. If there is no longer a declarant, the new owner needs to know that it has the right to build the buildings that will house its units.

It is the rare Wisconsin condominium declaration that addresses this issue. It is possible, however, to combine various emanations from Wisconsin statutes and common law to find the penumbras necessary to grant the new owner this right. Wis. Stat. section 703.04 states that a unit "for all purposes constitutes real property." Section 703.05 states that a unit owner "is entitled to the exclusive ownership and possession of his or her unit." Finally, the Wisconsin Supreme Court has consistently held that "public policy favors the free and unrestricted use of property," that "restrictions contained in deeds and in zoning ordinances must be strictly construed to favor unencumbered and free use of property," and that "restrictions on the use of property are to be construed in favor of free use."<sup>4</sup>

Putting all these together, a new owner who owns all the units in a nonexistent building should have the right to build the building and units. Otherwise, the new owner would be unable to enjoy the free and full use of its real estate or to exercise the exclusive ownership and possession to which it is entitled.

### **Amendments to the Condominium Documents**

The new owner's lawyer should carefully scrutinize the condominium documents to see whether any particular provisions should be amended to help the owner meet its objectives. In particular, the lawyer should consider whether amendments are needed to increase cash flow and promote sales. The lawyer may find that amendments are needed, for example, to relax restrictions on leasing, comply with Freddie Mac lending requirements, change the design of the units, change the number of units, or change the method of assessing unbuilt units.

Condominium declarations are difficult to amend. They require, in addition to the written consent of the owners holding at least two-thirds of the voting interests, the written consent

of those owners' mortgagees as well.<sup>5</sup> Even if the new owner owns a sufficient number of units to unilaterally amend the documents, it is politically smart to consult the resident owners before doing so. Happy resident owners promote sales; grumpy resident owners kill sales.

Restrictions on leasing. The condominium declaration, bylaws, or rules may contain restrictions or outright prohibitions on a unit owner's ability to lease the unit. Resident owners as a rule do not want the condominium to turn into an apartment complex. They would prefer that their neighbors be owners rather than renters for the following reasons: 1) owner occupants have a greater financial stake in the condominium and will likely take better care of the unit; 2) owner occupants will live in the condominium for longer periods than the renters and will therefore have a greater personal stake in the condominium; and 3) units that are in a predominantly owner-occupied condominium will hold their value better than those in a predominantly tenant-occupied condominium.

Chances are that the original developer got into trouble because it ran out of money while waiting for buyers to show up. The new owner does not want to make the same mistake. Until the market turns around, the new owner may need cash flow to cover its holding costs such as mortgage payments, taxes, and condominium dues. Even if it believes that the market for owner-occupied units will rebound, the new owner may still want to defray its holding costs by renting units temporarily. If it decides to operate the condominium as an apartment project, the new owner may want to eliminate the rental restrictions entirely.

Compliance with secondary market requirements. Before the current recession, many condominium documents did not comply with standards for condominium documents imposed by Fannie Mae, the Federal Housing Administration, Freddie Mac, and other secondary market lenders.<sup>6</sup> Because mortgage money was plentiful, many conventional mortgage lenders simply did not require compliance with these standards.

That has changed. Residential mortgage lenders now routinely require a legal opinion stating that the condominium documents comply with the secondary market standards. These standards are designed to protect mortgagees' right to participate in decisions involving such matters as amending the condominium documents, reconstruction following major damage, and termination of the condominium. The standards are not difficult to meet. The new owner can enhance the marketability of the units by amending the condominium documents to comply with the standards required by the new owner's lender.

Changing the design of the units. The developer's original sales plan may have failed because potential buyers rejected the units as originally designed. The developer of a slab-on-grade project designed for seniors, for example, may have underestimated the targeted buyers' need for basements in which to stockpile a lifetime's worth of accumulated possessions. Or the developer of a project consisting of two-story homes may have belatedly discovered that its targeted buyers preferred not to climb stairs.

A new owner (indeed, any unit owner) may alter those portions of the unit that are within the unit, that do not affect the structural integrity or lessen the support of any other portion of the condominium, and that do not create a nuisance. Any change to a unit that alters its exterior appearance requires approval of the condominium association's board of directors.<sup>7</sup> Altering the boundaries between a unit and the common elements is considerably more difficult. To do so requires amendments to the condominium declaration and plat, since those two documents define the original boundaries. An amendment to the declaration requires the written consent of the owners holding at least two-thirds of the voting interests as well as the written consent of those owners' mortgagees.<sup>8</sup>

Furthermore, if an amendment to a condominium declaration reduces the value of any unit owner's interest in any common element and increases the value of any other unit owner's

interest in the common element, the gainer must compensate the loser.<sup>9</sup> Changing the boundary of a unit such that it shrinks the common elements could trigger this provision.

Even if the two-thirds threshold is met and compensation is paid, an amendment to a declaration and plat that changes the boundaries between units and common elements is probably ineffective unless 100 percent of the unit owners execute a written conveyance. This is because each unit owner owns an undivided percentage interest in the common elements.<sup>10</sup>

Finally, any unanimous conveyance should be accompanied by the unanimous release by all mortgagees of their interest in those portions of the common elements to be converted into units. Otherwise, such portions will remain subject to the other unit owners' mortgages.

There is, however, an easier way to adjust a boundary between the common elements and a unit than amending the declaration and plat. The new owner and the association can create a *de facto* change in the boundary between a unit and the common element by having the association grant encroachment easements for the benefit of the new owner's units. Section 703.15(3)(b)3. gives the association the power to grant easements over the common elements, and section 703.15(1) grants the board of directors the power to make that decision on behalf of the association.

Thus, the new owner could redesign the units as desired via an amendment to the declaration and plat, if the unit owners holding at least two-thirds of the votes and their mortgagees consent to the amendment. To the extent that a building housing a unit encroaches into the common elements, the condominium association could grant that unit owner an encroachment easement. In approving such an easement, however, the association's directors must act in accordance with their fiduciary duty to the association's members.<sup>11</sup> One way they can do this is to have the new owner pay the association for the market value of the common elements subjected to the easement.

Changing the number of units. The new owner may want to change the condominium's number of units. The Act authorizes, under certain conditions, the division of one unit into several units<sup>12</sup> and the combination of multiple units into a single unit.<sup>13</sup> Any other changes likely require unanimous consent of all unit owners. The elimination of an existing unit requires unanimity because it requires a conveyance by the unit owner to the owners of the common elements, who are collectively all the unit owners. For the conveyance to be effective, it must be delivered under section 706.02(1)(g) to all owners of the common elements, namely, all the unit owners.

The creation of a new unit out of the common elements also requires unanimity, because it requires all unit owners to convey to one unit owner that portion of the common elements from which the new unit is created. It also requires the unanimous release by all mortgagees of their interest in the portion of the common elements to be conveyed. Otherwise, the unit will remain encumbered by other unit owners' mortgages.

Furthermore, any change in the number of units that changes the undivided percentage interest of unit owners in the common elements requires the unanimous written consent of all the unit owners and their mortgagees.<sup>14</sup>

Changing the method of assessing unbuilt units. Section 703.16(2)(a) provides that common expenses are to be assessed against the unit owners in proportion to their percentage interests in the common elements or as otherwise provided in the declaration. Often, declarations contain provisions for reduced or no assessments against the declarant's units. These provisions might not extend to units held by a new owner who has not taken an assignment of the declarant rights. If the condominium contains units that exist legally but have not yet been built, and the declaration does not exempt those units from

assessments, the new owner of such units may want to amend the declaration to exempt those units from assessments pending their completion.

## Conclusion

Every recession creates buying opportunities. A distressed condominium project, properly priced, can present such an opportunity. The lawyer for the new owner can play a key role in reducing the buyer's risk, increasing the project's value, and setting the project on the right course economically.

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### Endnotes

<sup>1</sup>See, e.g., *Franklin Condo Projects Face Foreclosure Action*, JS Online (March 5, 2009)

<http://www.jsonline.com/business/40816167.html>; *True Condo Inventory Remains in Shadow Market*, JS Online (March 20, 2009) <http://www.jsonline.com/business/41607057.html>; *Condoldrums: The Sluggish Housing Market Extends to Many of the Area's New Condominium Projects*, Wis. S. J., July 8, 2007.

<sup>2</sup>Wis. Stat. § 703.02(7).

<sup>3</sup>Wis. Stat. § 703.15(2)(c).

<sup>4</sup>*Crowley v. Knapp*, 94 Wis. 2d 421, 433, 288 N.W.2d 815 (1980) (citing *McKinnon v. Benedict*, 38 Wis. 2d 607, 619, 157 N.W.2d 665 (1968); *State ex rel. Bollenbeck v. Village of Shorewood Hills*, 237 Wis. 501, 297 N.W. 568 (1941); *Cohen v. Dane County Board of Adjustment*, 74 Wis. 2d 87, 91, 246 N.W.2d 112 (1976)).

<sup>5</sup>Wis. Stat. § 703.09(2).

<sup>6</sup>Standards imposed by the Federal Housing Administration, Freddie Mac, and Fannie Mae can be found at [www.allregs.com](http://www.allregs.com).

<sup>7</sup>Wis. Stat. § 703.13(5).

<sup>8</sup>Wis. Stat. § 703.09(2).

<sup>9</sup>Wis. Stat. § 703.09(3).

<sup>10</sup>Wis. Stat. § 703.13(1).

<sup>11</sup>Lisa M. Pardon, *Advising Developers in Operating Community Associations*, 77 Wis. Law., March 2004, at 12.

<sup>12</sup>Wis. Stat. § 703.13(7).

<sup>13</sup>Wis. Stat. § 703.13(8).

<sup>14</sup>Wis. Stat. § 703.13(4).

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## CURRENT RATES

Maturity	Today	Last week	Last month
5-year Treasury	2.53%	2.34%	2.33%
10-year Treasury	3.59%	3.39%	3.31%

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