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CONDOMINIUM INVESTMENTS AND THE INSTITUTIONAL LENDER — A RE-VIEW†

ROBERT M. ZINMAN*

In December 1963, William K. Kerr, then Associate General Solicitor of the Equitable Life Assurance Society of the United States, authored an article in the St. John's Law Review entitled Condominium — Statutory Implementation.1 This article was based in part on Mr. Kerr's paper, "Condominium, A Preview," delivered in May of 1962 before the Association of Life Insurance Counsel, and discussed the condominium concept, some legal problems then apparent, and some of the solutions to the legal problems afforded by then existing legislation.2

At the time Mr. Kerr wrote his paper and article, many questioned whether condominiums were an appropriate form of real estate investment for institutional lenders, and why institutions should be interested in the development of condominium laws. In the eleven years that have followed, we have seen the "spectacular sweep of condominium legislation across the land,"3 and the growth of public acceptance of the condominium form as evidenced by the recent tremendous surge in condominium development.4 At the same time, a virtual revolution was

†This article is based upon a paper presented by the author to the Association of Life Insurance Counsel on May 8, 1973. 23 Ass'n of Life Ins. Counsel Proc. 205 (1973). The author gratefully acknowledges the assistance of his associates: Carl D. Simoni of the New York Bar and Richard G. Clarke, a member of the Fordham Law Review, in connection with the 1973 paper; and Vincent Alexander and Irene Castaldo of the St. John's Law Review, in connection with this revision.

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2 Kerr, 16 Ass'n of Life Ins. Counsel Proc. 231 (1962) [hereinafter cited as Kerr Paper]. The paper was read before the Association of Life Insurance Counsel on Tuesday, May 29, 1962, at The Greenbrier, White Sulphur Springs, West Virginia. Mr. Kerr was then Associate Counsel for The Equitable Life Assurance Society.
3 Browder, Restraints on the Alienation of Condominium Units (The Right of First Refusal), 1970 U. Ill. L.F. 231 [hereinafter cited as Browder].
4 For example, the Wall Street Journal, March 29, 1973, at 1, col. 5, reported that "[a]ccording to National Association of Home Builders' surveys, condominiums accounted for 11% of 'for-sale built homes' in 1970, close to 30% last year and may approach 50% this year. Advance Mortgage Corp. says condos are 70% of apartment starts in the Miami area, 60% in Washington and San Diego, and more than half in Detroit. One real estate research man says they could be 'up to 50% of the multi-family market in Chicago, compared to no more than 5% five years ago. . .' The condominium trend is 'going to remain forever,' says Michael Sumichrast, chief economist of the NAHB. 'It is just surprising it didn't start a long time ago.'" Even discounting the natural
taking place in real estate financing practice and philosophy of institutional investors, putting life insurance companies and other institutions in the forefront of development of innovative approaches to real estate investment.

Over a decade ago the only area of investment in condominiums contemplated as a practical possibility by most institutions was mortgage investments on individual condominium units. Now, with the growing popularity of condominiums together with the change in approach of institutional investors, institutional involvement in condominiums is beginning to encompass not only mortgage investments, where the major emphasis still remains, but also sponsorship of condominium developments, and in some circumstances ownership of condominium units in commercial developments.

This article, which is also based upon a paper presented to the Association of Life Insurance Counsel, will view again the condominium picture from the standpoint of some of the current problems faced by, and some of the opportunities available to institutional investors as condominium mortgage lenders, as condominium sponsors and, to some degree, as condominium owners. In this connection, the life insurance company will often be considered typical of the institutional investor. While statutes governing other institutional investors
may vary from those affecting the life insurer, the problems confronted by all institutions are somewhat similar.

**The Institutional Investor as a Condominium Mortgagee**

When institutions first considered condominiums, many were concerned as to whether an investment in a condominium mortgage would be an authorized investment within the meaning of statutes regulating institutional investments. The fear was that ownership of a condominium unit together with an undivided interest in common areas might not be considered real estate. If such fears were well-founded, an investment in a condominium mortgage might not be an investment in a mortgage of real estate, and thus might be in violation of applicable regulatory statutes. The Kerr Paper did not feel that this was a significant problem, and events since this paper bear out the accuracy of its conclusions. Today, air space is generally recognized as real property, and most condominium statutes make this clear.

In addition to the foregoing, while it was generally felt that investment regulatory provisions requiring mortgages be a "first lien" on

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9 Kerr Paper, supra note 2, at 283.

10 See, e.g., Liebman, Development of Air Rights, N.Y.L.J., Nov. 12, 13, 14 & 15, 1968 (printed in four installments), at 1; Report, Recent Developments in Airspace Utilization, 5 REAL PROP. PROB. & TR. J. 347 (1970); Report, Final Draft of Model Airspace Act, 7 REAL PROP. PROB. & TR. J. 353 (1972). Section 3 of the Model Airspace Act, written under the auspices of the American Bar Association, and its Section on Real Property, Probate and Trust Law, states: "Airspace as defined herein is real property, and until title thereto or rights, interests or estates therein are separately transferred, airspace is the property of the person or persons holding title to the land surface beneath it." Model Airspace Act, in 7 REAL PROP. PROB. & TR. J. 504 (1975). Somewhat before the drafting of the Model Airspace Act, Lord Coke had said: "[T]he earth hath in law a great extent upwards, not only of water, as hath been said, but of ayre and all other things even up to heaven; for *cujus est solum ejus est usque ad coelum . . ."* 1 E. COKE, COMMENTARY UPON LITTLETON 4a (1670). The Latin translates as, "To whomsoever the soil belongs, he owns also to the sky . . ." BLACK'S LAW DICTIONARY 453 (4th ed. 1968).

11 "Basically, the statutes speak in terms of 'fee simple,' 'real property for all purposes,' and the right to 'exclusive ownership and possession.'" 1 P. ROHAN & M. RESKIN, CONDOMINIUM LAW AND PRACTICE § 1.01[2], at 1-7 (1972) [hereinafter cited as ROHAN & RESKIN].

12 In 1962 the FHA prepared and distributed a "Model Statute for Creation of Apartment Ownership" in order to facilitate the adoption of appropriate enabling legislation in the various states. U.S. FEDERAL HOUSING ADMINISTRATION, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, MODEL STATUTE FOR CREATION OF APARTMENT OWNERSHIP, FORM No. 3285 (1962) [hereinafter cited as FHA Model Act]. See Kerr, supra note 1, at 13.

13 N.Y. REAL PROP. LAw § 339-g (McKinney 1968).

realty would cause no problem, there was some concern with the validity of condominium mortgages under statutes requiring that the land be "unencumbered." Would the condominium declaration and bylaws to which the condominium is subject be encumbrances? The Kerr Paper concluded that they were no more than restrictive covenants which case law generally, and some state statutes specifically, held not to be encumbrances. The New York Condominium Statute, perhaps because of Kerr's concern, deals directly with the problem by providing that investments in condominium mortgages shall be considered legal investments for insurance companies and other institutional investors. This, however, appears to be an example of "overkill," and may actually restrict institutional investments in condominiums under so-called "basket" or "leeway" provisions. Of course, where there is any doubt as to the legal right of an institution to make condominium mortgage investments, it may be necessary to urge that either the condominium statute or the laws regulating the institution be amended to make it clear that such investments are permitted.

Once it has been determined that the condominium mortgage investment is a legal one for the institution, the next question is whether the institution should or would be willing to make such investments. The remainder of this part of the article will concentrate on some of the current problem areas which make such an investment more difficult than ordinary mortgage financing.

Common Expenses

In a condominium, each unit owner is liable for a proportionate share of the common expenses. If the unit owner fails to pay these charges, the association normally has a lien under the enabling statutes on the unit, superior to other liens, with certain exceptions. Such statutes generally protect the legality of the institutional mortgage by

16 Kerr Paper, supra note 2, at 283-84.
18 The language provides that insurance companies and certain other institutional investors may not invest in mortgages "which are other than first mortgages . . . notwithstanding any other provisions of law. . . ." N.Y. Real Prop. Law 339-ff(b) (McKinney 1968). An example of a New York "basket" or "leeway" provision is found in N.Y. Ins. Law § 81(17) (McKinney Supp. 1972), as amended, N.Y. Sess. Laws [1973], ch. 1020 (McKinney).
19 These exceptions generally include, inter alia, first mortgages and deeds of trust, and tax liens. See N.Y. Real Prop. Law § 339-z (McKinney Supp. 1973). California provides that such lien "shall be prior to all other liens recorded subsequent to the recordation of said notice of assessment except that the declaration of restrictions may provide for the subordination thereof to any other liens and encumbrances." Cal. Civ. Code § 1256 (West Supp. 1973) (emphasis added).
making the lien for common charges subordinate to at least first mortgages of record.\textsuperscript{20} A notable exception is the Illinois statute which provides that if the board of managers properly sends successive notices of the unit owner's successive defaults to the mortgagee, the mortgage will (unless otherwise provided in the declaration or bylaws) be subject to the lien for common expenses becoming due and payable within ninety days after the mailing of each such notice.\textsuperscript{21} Nevertheless, cautious institutions may still have some question as to whether this statute passes muster under applicable laws regulating mortgage investments.\textsuperscript{22}

Notwithstanding the protection afforded to mortgagees as against the lien for common expenses, commentators have questioned whether in some states the accrued common expenses allocable to a foreclosed unit may be charged to the foreclosing mortgagee or other purchaser at the foreclosure sale.\textsuperscript{23} It would seem that in any state where the mortgage is superior to the lien for common expenses, foreclosure of the mortgage should cut off the common expense lien. To permit the association, after foreclosure, to reassess the past due expenses and create a new lien therefor against the new owner would simply not make sense. In any case, there should be no problem where the state has adopted the FHA Model Act provision to the effect that the acquiring mortgagee, his successors and assigns shall not be liable for the prior unpaid common expenses and that such unpaid charges will become common expenses collectible from all the owners including the mortgagee.\textsuperscript{24}

\textsuperscript{20} Some statutes, such as Florida's, go further, and provide that the lien "shall be subordinate to the lien of a mortgage or other lien recorded prior to the time of recording of the claim of lien." FLA. STAT. ANN. § 711.15(4) (1969).

\textsuperscript{21} ILL. ANN. STAT. ch. 30 § 309 (Smith-Hurd 1969). Other statutes may impose conditions on the priority of the mortgage. For example, Missouri requires that the mortgage contain an address of the mortgagee in Missouri for mailing of notices. Mo. ANN. STAT. § 448.080(2) (Supp. 1974). Obviously the language of each applicable statute must be studied carefully.

\textsuperscript{22} See, e.g., N.Y. INS. LAW § 81(6)(a) (McKinney Supp. 1972) which provides, \textit{inter alia}, "Nothing herein shall prohibit any investment by reason of the existence of any prior lien for ground rents, taxes, assessments or other similar charges not yet delinquent." Thomas H. Fegan, Associate General Counsel, Equitable Life Assurance Society, and a member of the committee that drafted the Illinois statute, has stated with respect to the Illinois provision that "it was a situation that could be corrected easily by the payment of money, could be made a default under the mortgage, and the amount spent could be added to the debt and, therefore, was not of sufficient importance to prevent the making of loans." Fegan, \textit{Financing Condominiums}, in PRACTICING LAW INSTITUTE, COOPERATIVES AND CONDOMINIUMS 246, 268 (J. McCord ed. 1969) [hereinafter cited as Fegan]. He noted, however, that he "would prefer not to have to contend with it and will make every effort to have it waived if we are involved in a project early enough to influence the drafting of the Declaration and Bylaws, provided we feel that it will not adversely affect the sales program." Id.

\textsuperscript{23} See I ROHAN & RESKIN § 6.04[3].

\textsuperscript{24} FHA Model Act, \textit{supra} note 12, at § 23(b). Each statute must be studied carefully
Even though the mortgagee is generally protected against liens for common expenses prior to foreclosure, the mortgagee as a unit owner will become subject to payment of the unit's proportionate share of future common expenses. As more and more unit owners default, the share of common expenses of the remaining unit owners is likely to increase. This is further exacerbated in New York where the statute exempts municipal corporations acquiring a unit in tax enforcement proceedings from liability for payment of common expenses applicable to such unit during the period the municipal corporation holds title to such unit, except to the extent of rent received by the municipal corporation from the unit during such period.\textsuperscript{25} Thus, the mortgagee on foreclosure may find that the common expenses allocable to the foreclosed unit are far greater than they should be,\textsuperscript{26} especially where the mortgagee is a "spot mortgagee" in that it does not hold all or a vast majority of the mortgages on the condominium units.\textsuperscript{27} This problem is compounded where the condominium is on leasehold property and the common charges include ground rent,\textsuperscript{28} or if any part of the common property is covered by a blanket mortgage,\textsuperscript{29} thus increasing common charges for interest and principal payments.

\textit{Restrictions on Sale and Lease}

If a condominium unit is mortgaged, that mortgage may some day be foreclosed, and the institution holding that mortgage may find itself in the position of a condominium unit owner. In this event, the mortgagee will wish to sell the property, and, until a sale is consummated, lease it. However, many condominium documents restrict the ability to insure that this freedom from liability for pre-foreclosure common expenses inures to the benefit of transferees from the mortgagee. Also, the declaration and bylaws must make it clear that unit owners (including the foreclosing mortgagee) are not liable for common expenses arising after they have conveyed the property.

\textsuperscript{25} N.Y. \textsc{Real Prop. Law} § 339-aa (McKinney 1968).
\textsuperscript{26} In this connection, the applicable statute should be checked to make certain that the unit is protected against mechanics' liens for improvements to the common areas. For example, New York provides that except for emergency repairs, labor performed or materials furnished in connection with a unit shall not be the basis of a lien on any unit unless the unit owner consented to the repairs. Labor performed or materials furnished in connection with the common elements shall not be the basis for a lien on the common elements, but the common charges are made trust funds for such payment. N.Y. \textsc{Real Prop. Law} § 339-1(2) (McKinney 1968). Several other statutes provide a pro rata lien on each unit if the work was authorized by the condominium association. See, \textit{e.g.}, \textsc{Cal. Civ. Code} § 1357 (West Supp. 1973).
\textsuperscript{27} Hereinafter, a mortgagee of a condominium unit who does not hold a substantial portion of the unit mortgages in the condominium shall be referred to as a "spot mortgagee."
\textsuperscript{28} See text accompanying notes 202-21 \textit{infra}.
\textsuperscript{29} Id.
to sell or lease. Such restrictions, if valid, would at best make more difficult realization of the protection afforded by the mortgage, and at worst, if the restrictions are too severe, could be violative of laws regulating institutional investments.30

The restrictions found in condominium documents include outright prohibition unless approval is obtained from the association or board of managers, a right of first refusal under which the association or board may match bona fide offers, a right of first refusal or option at fair market value or a fixed price, and a right to supply a purchaser to meet the terms of a bona fide offer.31

The consensus appears to be that unless the condominium enabling statute permits such restraints, and many attempt to do so,32 these restraints, at least as far as they affect sales,33 would probably be in technical violation of the Rule Against Perpetuities or prohibitions against restraints on alienation.34 But at the same time, the consensus appears to oppose the technical application of these prohibitions to condominiums, in favor of an approach which would permit reasonable restraints in the interest of encouraging accepted social or economic

30 See, e.g., N.Y. Ins. Law § 78(2) (McKinney 1966) which reads in part as follows: "The disposition of its property shall be at all times within the control of its board of directors, in accordance with its charter and by-laws." While it could be argued that a prohibition of sale without consent of the association might take the asset out of the control of the directors, it could also be argued that the asset is the mortgage and at least until default, may be disposed of by the insurance company.
31 See 1 ROHAN & RESKIN § 13.03[5], at 13-24; Berger, Condominium: Shelter on a Statutory Foundation, 63 Colum. L. Rev. 986, 1017 (1963) [hereinafter cited as Berger]; Browder, supra note 3, at 237-43.
32 See, e.g., R.I. Gen. Laws Ann. § 34-36-28 (1970), which states: "The rule of property known as the rule against perpetuities and the rule of property known as the rule restricting unreasonable restraints on alienation shall not be applied to defeat any of the provisions of this chapter, or of any declaration, by-laws or other document executed in accordance with this chapter." See also N.Y. Real. Prop. Law § 339-v(2)(a) (McKinney 1968) which states that the bylaws may contain

[p]rovisions governing the alienation, conveyance, sale, leasing, purchase, ownership and occupancy of units provided, however, that the by-laws shall contain no provision restricting the alienation, conveyance, sale, leasing, purchase, ownership and occupancy of units because of race, creed, color or national origin. Unlike the Rhode Island statute, the New York version does not specifically rule out application of the perpetuities or alienation restraint doctrines to condominiums and might be interpreted, however incorrectly, to permit only otherwise lawful restraints. But see PRACTISING LAW INSTITUTE, COOPERATIVES AND CONDOMINIUMS 385-86 (J. McCord ed. 1969) [hereinafter cited as PLI TRANSCRIPT).
33 Restrictions on the ability to lease are often upheld where restrictions on the ability to sell would fail. But see Berger, supra note 31, at 1019.
34 See 1 ROHAN & RESKIN 10.05[1], at 10-16, 17, where the authors state, "If the whole body of law pertaining to restraints on the alienation of a fee is applied to the question of the legality of a restraint on alienation by a condominium right of first refusal, the restraint will probably be held invalid." But see Moller, The Condominium Confronts The Rule Against Perpetuities, 10 N.Y.L.F. 377 (1964) who argues forcefully that these rules should not apply to the right of first refusal.
ends. A leading case involving a cooperative housing association explained this view in upholding a right of first refusal, in language, at least, which would seem applicable to condominiums. Fortunately for the lender, the harsher the restraint the more chance that it will be declared invalid. Nevertheless, whatever the chance that the restraint is invalid, an institution may not want to take the chance that it will be upheld.

In many cases restrictions on sale or lease are no problem since the declaration or bylaws imposing such restraints make exception for a foreclosing first mortgagee, permitting such mortgagee to sell or lease the premises without restriction. While such exceptions on behalf of the first mortgagee may diminish the protection desired by purchasers of condominium units, without such an exception institutions must accept a degree of risk not generally required to be assumed in the ordinary home mortgage situation.

Tort Liability and Corporate Ownership of Common Areas

A condominium purchaser is not only owner of his own unit, but also normally an owner, as tenant in common, of the common areas. As such, it would seem that the condominium owner would be subject to joint and several liability arising out of the tort claims against the condominium association in connection with the common areas. The

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35 See Browder, supra note 3, at 255-59. Of course, discrimination on the basis of race, creed, color, sex, national origin, or age, would not be permitted, since it would violate applicable laws against discrimination.

36 Gale v. York Center Community Co-op, Inc., 21 Ill. 2d 86, 171 N.E.2d 30 (1960). It should be noted that restraints have generally been upheld with respect to cooperatives (as distinguished from condominiums) on the ground that they do not involve fee interests in real property to which rules against perpetuities and restraints on alienation are generally considered applicable. See Kerr Paper, supra note 2, at 280.

37 From the authorities here mentioned and many others examined, it would appear that the crucial inquiry should be directed at the utility of the restraint as compared with the injurious consequences that will flow from its enforcement. If accepted social and economic considerations dictate that a partial restraint is reasonably necessary for their fulfillment, such a restraint should be sustained. 21 Ill. 2d at 92, 171 N.E.2d at 33.

38 See, e.g., Declaration, Three Fountains (Salt Lake City, Utah 1964), § 22, reprinted in 1A ROHAN & RESKIN app. 169:

If the purchaser following such foreclosure sale (or grantee under deed given in lieu of such foreclosure) shall be the then holder of the first mortgage, or its nominee, the said holder or nominee may thereafter sell and convey the condominium free and clear of the provisions of Paragraph 21 [right of first refusal], but its grantee shall thereupon and thereafter be subject to all the provisions thereof.

parade of possible exposure has been set forth in several articles and runs the gamut from negligence of maintenance personnel and violation of fire and building codes to failure to maintain workmen's compensation policies and products liability where food, beverages, or detergents are dispensed through vending machines. To add to these delightful prospects, a recent California case would indicate that negligence liability might not be limited to outsiders, and that individual unit owners might have a claim against the association for injuries occurring in the common areas.

Normally, when a mortgagee forecloses a mortgage and becomes the owner of the mortgaged property, it obtains, or places the property under its own liability insurance coverage. If the lender is a spot mortgagee in a condominium, the liability coverage required might be much greater than the amount of the mortgage would justify. When the mortgagee holds mortgages on all or a major portion of the condominium units, the problem may be substantially mitigated as will be seen below. But where the institutional lender is a spot mortgagee, it is essential that adequate insurance coverage be obtained by the condominium association or that other forms of protection be secured.

Normally the declaration or the bylaws will make provision for insurance. Often, however, the section dealing with the amount of liability coverage merely states that it be "in such limits as the Board of Managers may from time to time determine." This, of course, is not

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41 In White v. Cox, 17 Cal. App. 3d 824, 831, 95 Cal. Rptr. 259, 263 (Dist. Ct. App. 1971), the court held that a "condominium association may be sued for negligence in its common name... by a member of the association... who may obtain a judgment against the condominium and the condominium association." The court found that (a) a condominium project and a condominium association are separate legal entities from their unit owners and association members; and (b) a condominium owner normally has no more control over operation of the common areas than he would have as a stockholder in a corporation. Id. at 829-30, 95 Cal. Rptr. at 262-63. Thus, plaintiff could not be barred from recovery under either the "joint enterprise" or "co-ownership" theories generally employed to contest authority of condominium owners to maintain an action against the association. This case is noted in 8 Cal. W.L. Rev. 586 (1972); 40 Fordham L. Rev. 627 (1972); 25 Vand. L. Rev. 271 (1972). In this connection see Fed. R. Civ. 17(b).

42 In some cases it may be possible to place the unit under a blanket liability policy held by an institutional mortgagee with no additional initial cost. However, in many of these policies, recoveries are reflected in future premiums.

43 See text accompanying notes 104-30 infra.

44 See Bylaws, St. Tropez Condominium, (New York, N.Y. 1965) reprinted in 1A Rohan & Reskin, app. C-1, at 101:

The Board of Managers shall also be required to obtain and maintain, to the extent obtainable, public liability insurance in such limits as the Board of Managers may from time to time determine, covering each member of the
very reassuring to the mortgagee. Even where amounts and coverage that the mortgagee considers adequate are specified in the bylaws, one must consider what would happen if the bylaws are later amended, if the condominium association does not have the funds to pay the premium or otherwise fails to keep the policy in force, or if the conditions of the policy are violated. Again, if the mortgagee holds the major portion of the mortgages on the condominium, it can prevent modifications of the bylaws and require that insurance be kept in force through properly drafted default provisions in the mortgages. If the mortgagee does not hold many mortgages, threat of foreclosure will not necessarily result in the obtaining of the proper insurance by the association, and foreclosure will only put the mortgagee in title, subject to all the uninsured liabilities.

In a few jurisdictions, a statutory solution has been sought for the unit owner's tort liability. For example, some states provide that the unit owners have no liability for torts committed by the condominium association. Others provide that an owner's liability is limited to the unit owner's proportionate share of the judgment. These statutes would seem to give the unit owners, and thus the foreclosing mortgagee, the kind of protection that is necessary. If the condominium association fails to carry adequate insurance, on foreclosure the mortgagee can obtain, or put the property under, its own policy under circumstances in which the insurance coverage would bear a reasonable relationship to the amount of the investment.

While a statutory solution to this problem would seem to be the most advisable, where such protection is not afforded other solutions must be sought. It has been suggested that the common areas be held by a corporation with the unit owners owning their unit in fee, and stock

Board of Managers, the managing agent, the manager, and each unit owner. Such public liability coverage shall also cover cross liability claims of one insured against another.

45 See, e.g., FLA. STAT. ANN. § 711.18(2) (1969), which provides:
The owner of a unit shall have no personal liability for any damages caused by the association on or in connection with the use of the common elements. A unit owner shall be liable for injuries or damages resulting from an accident in his own unit to the same extent and degree that the owner of a house would be liable for an accident occurring within his house.

46 See, e.g., WASH. REV. CODE ANN. § 64.32.240 (1966), which provides in part:
Actions relating to the common areas and facilities for damages arising out of tortious conduct shall be maintained only against the association of apartment owners and any judgment lien or other charge resulting therefrom shall be deemed a common expense, which judgment lien or other charge shall be removed from any apartment and its percentage of undivided interest in the common areas and facilities upon payment by the respective owner of his proportionate share thereof based on the percentage of undivided interest owned by such apartment owner.

See also ALASKA COMP. LAWS ANN. § 34.07.260(b) (Supp. 1971).
in the corporation, thus avoiding the unit owners’ unlimited liability.\textsuperscript{47} However, while the courts normally respect the corporate entity, there is always the danger that they will “pierce the corporate veil.”\textsuperscript{48} In the condominium situation, the most obvious danger areas that might lead a court to disregard the corporate entity would seem to arise from: (a) the unit owners or the association not respecting the corporate entity; or (b) the existence of easements or liens held by the unit owners which might so reduce the value of the corporation’s fee title that it would be considered too severely undercapitalized.\textsuperscript{49} As to (a), the spot mortgagee may have difficulty in controlling the action of the unit owners and the association, and as to (b), there is good question as to whether any mortgagee would want to have valuable common areas owned outright by the corporation and subject to being sold to satisfy a judgment lien.

In addition to the problems of the corporate entity, there are a number of other problems arising from corporate ownership of the common areas involving both condominium law and tax law. One problem is whether the condominium enabling statutes require amendment to permit corporations to own the common elements. Some of the statutes specifically permit incorporation of the association,\textsuperscript{50} but these provisions do not necessarily permit the incorporated association to own the common elements.\textsuperscript{51} Most of the statutes in this connection

\textsuperscript{47}See Knight, supra note 40, at 7-9; Schreiber, supra note 39, at 1143-44; Note, Condominiums: Incorporation of the Common Elements—A Proposal, 23 VAND. L. REV. 321 (1970) [hereinafter cited as Incorporation of the Common Elements].

\textsuperscript{48}The general rule is that a corporation is an entity separate and apart from its stockholders and that its stockholders are not personally liable for the debts of the corporation. Under some circumstances, however, the courts have pierced the corporate veil. These circumstances generally involve situations where the corporation is undercapitalized, the corporate entity is disregarded by the principals, or the corporation is held to be a “mere instrumentality” of the parent. Compare Arnold v. Phillips, 117 F.2d 497 (5th Cir.), cert. denied, 313 U.S. 583 (1941), with Bartle v. Home Owners Coop., Inc., 309 N.Y. 103, 127 N.E.2d 832 (1955). See generally H. BALLANTINE, CORPORATIONS §§ 118-142 (rev. ed. 1946).

\textsuperscript{49}This may become a greater problem in connection with the alternative proposal discussed in the text at note 63 infra.

\textsuperscript{50}See, e.g., N.J. STAT. ANN. § 46:8B-12 (Supp. 1973) which provides in part: “The association may be any entity recognized by the laws of New Jersey, including but not limited to a business corporation or a nonprofit corporation.” See Anderson, Tax Aspects of Cooperative and Condominium Housing, N.Y.U. 25TH INST. ON FED. TAX. 79, 89-98 (1967) [hereinafter cited as Tax Aspects].

\textsuperscript{51}A recent decision in California contains dictum to the effect that a corporation cannot “properly” hold title to the common elements. See Friendly Village Community Ass’n, Inc. v. Silva & Hill Constr. Co., 31 Cal. App. 3d 220, 225 n.3, 107 Cal. Rptr. 128, 126 n.3 (Dist. Ct. App. 1973) where a condominium association, incorporated only for the purpose of providing management services, sued the builders of the condominium for negligent construction. The court denied the corporation’s standing to sue, holding that the unit owners were the real parties in interest, that is, the parties having an ownership
are gems of ambiguity. The New York statute is typically confusing. As can best be determined, it would seem that each owner must own in fee simple absolute only his unit and that such unit must exit on a public street or common element leading to such a public street. Each unit must have a common interest, i.e., a proportionate interest in the common elements appurtenant to it, and such common interest must have a permanent character and may not be altered without the consent of all unit owners affected. The common elements may include whatever the declaration says they include, but apparently must include an entry to a public street by virtue of the definition of unit.

Since the New York statute does not say that the common elements must be owned in fee simple absolute and defines unit owner only as a person owning "a unit" in fee simple absolute, it is possible to argue that the common elements can be owned by a corporation with the unit owner holding an easement or the stock of the corporation. A

or possessory interest. In a footnote, the court examined the definitions of "condominium," "unit," and "common areas" provided in the California statute and concluded:

Because of the nature of a condominium, the complaint could not properly have alleged ownership in plaintiff [management corporation] ... [T]he owners of a condominium are the grantees of the units, each grantee owning a separate interest in his unit and an interest, as tenant in common, in the common areas. Id. In reaching this conclusion, the court seemed to rely primarily on a section of the California condominium statute which states that "[t]he common areas are owned by the owners of the units as tenants in common, in equal shares, one for each unit." Cal. Civ. Code § 1353(b) (West Supp. 1974). Since § 1350(4) defines "common areas" to mean "the entire project excepting all units," the extent of individual liability arising from joint ownership in California would presumably be dependent on the extent of the common areas included in the project. Thus, if limited liability via the incorporation route is desired in California, it might still be possible to adopt the approaches discussed for New York, in the text at note 57 infra.

The definition of "unit" says that it means "a part of the property intended for any type of use or uses. . . ." N.Y. REAL PROP. LAW § 339-e(13) (McKinney 1968). The FHA Model Act, from which this may have been derived, uses the word "apartment" in lieu of "unit" and provides that "apartment" means "a part of the property intended for any type of independent use. . . ." FHA Model Act, § 2(a) (emphasis added). This seems to make a little more sense. Under the New York version, the common swimming pool seems to fit within the definition of "unit."

N.Y. REAL PROP. LAW § 339-i(1). One writer has suggested that a provision such as this would have to be amended to permit ownership of the common elements by a corporation. Incorporation of the Common Elements, supra note 47, at 331. It should be noted, however that this would only seem a problem when the common interest is first owned by the unit owners and thereafter an attempt is made to convey the fee title to the common interest to a corporation. If the condominium is initially formed with the unit owners having fee title to their unit and an easement from, or stock ownership in the corporation owning the common areas, assuming this is permitted by the statute, there will be no need to separate the common interest from the unit.

The definition of "common elements" (N.Y. REAL PROP. LAW § 339-e(3) (McKinney 1968)) applies "unless otherwise provided in the declaration." Id.

The definition of "property," a term which is used in the statute in connection with, inter alia, administration and distribution of profits, reads as follows: "'Property'
slightly more cautious argument in New York might be that it would be possible to keep the title to the common elements in the unit owner, but limit the common elements to that needed to give entry to a public street and put title to the recreational facilities and the like in a corporation, thus somewhat limiting, but not eliminating, the tort risk.

Another problem pointed out by one writer\(^5\) is that if the unit owner does not own an interest in the common areas, the value of his real property for mortgage purposes would be limited under most investment statutes to the value of the unit itself, thus resulting in a smaller legal loan limit. But perhaps the greatest problem would be in the area of taxation. A stockholder cannot normally deduct real estate taxes imposed upon the corporation in which he owns stock since the deduction applies to the person on whom the taxes are imposed.\(^6\) It is for this reason that the Internal Revenue Code specifically provides that shares in a cooperative may be treated as real property for tax purposes.\(^6\) Thus, it would appear that special legislation on the federal level would be required before the corporate ownership proposal could be a practical solution. Until such legislation is obtained, there would be a serious tax disadvantage to corporate ownership of the common areas, although an appropriate part of the real estate taxes for the common areas might be used by the corporation to offset income means and includes the land, the building and all other improvements thereon, owned in fee simple absolute, and all easements, rights and appurtenances belonging thereto, and all other property, personal or mixed, intended for use in connection therewith, which have been or are intended to be submitted to the provisions of this article." N.Y. REAL PROP. LAW § 339-e(11) (McKinney 1968) (emphasis added). The emphasized "owned in fee simple absolute" unfortunately does not indicate by whom. Thus, it could be argued that since the corporate association would own the common elements in fee simple absolute the common elements would be "property." However, since most real property is owned by someone in fee simple absolute, this interpretation would render the statutory clause meaningless. Notwithstanding the foregoing, easements from, or stock of, the corporate owner would seem to fit within the emphasized "easements, rights and appurtenances . . . intended to be submitted to the provision of this article." For a recent amendment including leaseholds in the definition of "property" for nonresidential condominiums, see note 214 infra.

Knight, supra note 40, at 9-10.


\(^6\) INT. REV. CODE of 1954, § 216. See also id. § 1034(f). It does not appear that a corporation owning the common areas of a condominium could be considered as a "cooperative housing corporation" within the § 216(b)(l) definition which requires, inter alia, that each stockholder be entitled "solely by reason of his ownership of stock in the corporation" to occupy his unit. Nevertheless, it does seem incongruous to give cooperative stockholders the tax advantages of individual ownership of real estate, while denying such tax advantages to individual condominium owners of real estate who have put common areas in a corporation to obtain the type of liability protection available to cooperative stockholders. In light of this, a clarification of the Internal Revenue Code might be a feasible solution.
from commercial facilities in such areas. If there is such income, and it exceeds the deductions therefor, there may also be a problem of double taxation, as income would be taxable to the corporation at the corporate rate and then taxable to the unit owners as dividends. Double taxation, as one writer has pointed out, could, at least under some circumstances, be disastrous.

There is, however, at least one variation of the corporate ownership proposal which would eliminate or substantially reduce some of the problems discussed. It has been proposed that the unit owners continue to own the common areas but lease these interests to a corporation to run them. Thus, it was argued, it would be unnecessary to decide whether a corporation could hold title to the common areas; the common areas can be valued for mortgage purposes; real estate taxes can be deducted by the unit owners, who would remain obligated to pay them; and the unit owners could in most cases avoid liability for other than their own acts in the common areas, although it is possible that in some circumstances this liability may survive. Where the common areas include commercial facilities whose income is greater than the applicable deductions, one writer has suggested that it might be possible to have rent payable or attributable from the corporation to the unit owners, thus avoiding, or at least minimizing, double taxation. This may run into serious objections from the IRS and was apparently written prior to the adoption of section 277 of the Internal Revenue Act.

See INT. REV. CODE of 1954, § 277, and note 66 infra for limits on the extent of the corporation's tax deductions.


Knight, supra note 40, at 11.

The duty of care to make or keep premises safe—where it exists at all—generally rests upon the person who has occupancy or possession of the premises. If premises are leased, the tenant is generally considered as entitled to exclusive possession of them, and therefore alone liable to visitors for injuries caused by their dangerous condition or use.

Anderson, supra note 62, at 229-30; Tax Aspects, supra note 50, at 97-98. A similar argument might be made in connection with the corporate ownership proposal, under which the fees paid by the unit owners to the corporation owning the common areas would be so set by contract that the expenses of the corporation in operating the common areas would equal the payments by the unit owners plus the income from the commercial facilities. But see note 67 infra and INT. REV. CODE of 1954, § 277, and Proposed Treas. Reg. §§ 1.277-1-3, 57 Fed. Reg. 9278 (1972), under which certain membership organizations may take deductions attributable to furnishing services to members only to the extent of income derived from members or transactions with members. The proposed regulation will consider as income from members that portion of rent received from commercial facilities equal to the percentage of the total income of the facility that came from members. Id. § 1.277-1(d)(2).
which restricts this possibility. In addition, the corporation holding a leasehold which is producing little or no net income might be subject to attack on its corporate entity on the ground of undercapitalization.

Thus, the corporate solution may create more problems than it solves. The real solution, therefore, lies in the amendment of enabling legislation limiting a unit owner's tort liability. Absent such legislation, the condominium spot mortgagee may have to assume some greater risks, or incur some greater expenses, than might normally be associated with mortgage lending.

Casualty Insurance

It has been said that the "attorney who seeks to draft a viable casualty insurance program is confronted by a legal Gordian knot of complex and often inconsistent rights and duties incident to the condominium." From the mortgagee's point of view, it is essential that this knot be untied. For the mortgagee must require adequate insurance for both the common elements and the individual units.

The enabling statutes, if they have developed any consistent trend, seem to have adopted a "permissive duplication of coverage" approach which provides for a master policy for the entire condominium but per-

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67 See INT. REV. CODE of 1954, § 277, and Proposed Treas. Reg. §§ 1.277-1-3, 37 Fed. Reg. 9278 (1972), discussed in note 66 supra. Also, the IRS might take the position that: (a) the expenses of the corporation for the operation of the common areas unassociated with the commercial facilities are not ordinary and necessary business expenses and thus might not permit the deduction to the corporation; (b) where rent is "paid" by the corporation so as to reduce the common area payments, an amount should be attributed to the unit owners' common area payments, and thus to the corporation's income, equal to an amount by which rental income from commercial facilities reduced the actual payments, which reduction helped discharge a legal obligation of the unit owners; and (c) the application of rental income from commercial areas to reduce the unit owners' common area expenses (or the direct payment of rent) is an economic benefit from the corporation to its shareholders in the form of dividends, thus resulting in double taxation. See 1 ROHAN & RESKIN § 15.06(2), where the authors discuss these possible arguments and cite Chicago & W. Ind. R.R. v. Commissioner, 303 F.2d 796 (7th Cir.), vacated on other grounds, 310 F.2d 380 (7th Cir. 1962). In that case, the court, employing all three arguments, held that where a group of railroad companies held stock of a terminal corporation that serviced both owner and nonowner railroads, the net income from the nonshareholder railroads constituted taxable income to the terminal railroad corporation when applied to reduce charges to the shareholder railroads. Anderson's suggestion (see text accompanying note 66 supra) is somewhat distinguishable in that the commercial income is not directly being used to reduce unit owner expenses, but is being paid to the unit owners as rent under a lease. However, this may be a difference in form over substance.

68 See note 48 and accompanying text supra.

69 The problems may be mitigated to some degree by providing for contribution in the condominium association bylaws. For a discussion of this approach, see Lawrence, supra note 40, at 799.

70 1 ROHAN & RESKIN § 11.07 (footnote omitted).

71 Id. § 11.03[1], at 11-14.
mits unit owners to acquire their own coverage. For example, the New York statute states that the board of managers shall obtain coverage for the "building" if such coverage is "required by the declaration, the by-laws or by a majority of the unit owners," but such insurance shall be "without prejudice to the right of each unit owner to insure his own unit for his own benefit." There are many variations on this theme, some which give the mortgagee the right to require the master coverage, and a few of which require such master coverage. While most specifically permit individual policies, there are a few that remain silent on this. None of the statutes adequately correlate the owner, mortgagee, and association requirements.

The casualty insurance industry urges that "it is clearly preferable that insurance on the building, including the customary building items, be written in a single policy (or concurrent policies)." Most bylaw provisions specify that the property will be insured by the association, usu-

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72 The use of the word "building" is somewhat confusing. The act defines "building" as a "multi-unit building or buildings, or a group of buildings whether or not attached to each other, comprising a part of the property." N.Y. REAL PROP. LAW § 339-e(1) (McKinney 1968). It would seem that such common facilities as swimming pools, cabanas, and the like may be excluded from this definition. The statute, of course, is merely permissive and provides for the insurance coverage only if the declaration, bylaws or majority of unit owners require it. Since it is permissive, the next question is, is such permission necessary, and if it is necessary, is the board of managers thereby precluded from obtaining such blanket insurance for other than the "building"?

73 Id. § 339-bb. The right of the unit owner to obtain his own insurance may be essential, especially if he has made substantial improvements to his unit on his own.

74 See, e.g., Wis. STAT. ANN. § 703.25 (Spec. Pamphlet 1973): "[T]he manager or the board of directors . . . at the request of the holder of a first mortgage of record covering a unit, shall . . . obtain insurance for the property against the loss or damage by fire and such other hazards under such terms and for such amounts as is . . . requested." A mortgagee's dream?

75 See, e.g., ILL. ANN. STAT. ch. 30, § 312 (Smith-Hurd Supp. 1973), which provides, inter alia, that "the manager or the board of managers shall have the authority to and shall obtain insurance for the property against loss or damage by fire and such other hazards as are covered under standard extended coverage provisions for the full insurable replacement cost of the common elements and the units."

76 Rohan and Reskin note that faced with the question of duplication of coverage, some attorneys active in the condominium field argue that the clause preserving the unit owner's right to obtain insurance should be read as being limited: 1) to a situation where the association has not purchased a master policy, or 2) to apply only to personal property. It would seem that the authors are clearly correct when they state that "it is extremely doubtful that either view can be supported." 1 ROHAN & RESKIN § 11.03[1], at 11-14.1.

77 See, e.g., OHIO REV. CODE ANN. § 5311.16 (Page 1971).

78 Fire, Cas. & Sur. Bull., Fire & Marine Vol., Misc. Fire Section, July 1966, at C-5. The bulletin, published by the National Underwriter Company, goes on to explain that if each owner had individual coverage, "it is easy to imagine the resultant problems with Co-insurance requirements, maintenance of insurance to value (actual cash value or replacement cost) and in adjusting losses which might involve several of the units plus a part of the common elements of the building. For these same reasons a single policy covering the entire condominium building is equally advantageous to the unit owner." Id.
ally with permission for the individual unit owners to obtain their own coverage. Unless the lender holds mortgages on a large proportion of the units in a condominium, it will be difficult for the lender to maintain any right to approve the carrier or to control the amounts and types of insurance obtained by the association under a master policy, even if the bylaws, at the time the mortgages are made, specify adequate insurance, although some state statutes require that the board of managers obtain insurance "for the full insurable replacement cost of the common elements and the units." On the other hand, individual coverage for each unit, while giving the mortgagee control over its adequacy, may not provide funds to permit repair of common elements in the event of major damage to the condominium. As a result, some combination of the two forms is needed. However, there are numerous as yet unresolved problems, created not only by the very nature of the condominium but also by the attempts to combine master and individual coverage. A discussion of some of the problems affecting the mortgagee follows.

A. Application of Proceeds

The mortgagee normally wants the option to apply the insurance proceeds to restoration or to reduction of the debt. This right may have to be sacrificed if a viable condominium is to be established and, indeed, some statutes so provide. Clearly, the condominium association cannot permit an individual mortgagee to thwart restoration plans by insisting that its share of a master policy award be applied to his debt. With respect to individual policies, the mortgagee could conceivably have a freer hand, but even there the value of all the units will be affected by the failure of one or more owners to restore.

Rohan and Reskin discuss an interesting solution contained in the

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70 "Failure of project draftsmen to go further and correlate the insurance activities of the unit owners, mortgagees, and association may merely reflect a carry-over of the imprecision of the enabling legislation." 1 Rohan & Reskin § 11.09[3], at 11-20.

80 Bylaw provisions can generally be altered or repealed by a vote of a specified percentage of unit owners.

81 Ill. Ann. Stat. ch. 30, § 312 (Smith-Hurd Supp. 1973). See Even, The Administration of Insurance for Condominiums, 1970 U. Ill. L.F. 204, 206-09 [hereinafter cited as Even]. The Illinois statute does not provide for special types of insurance the mortgagee may think important, such as coverage for contractual liability on leased equipment. See id. at 209-12.

82 For an excellent general discussion of casualty insurance problems, see 1 Rohan & Reskin §§ 11.01-08.

Strata Titles legislation of New South Wales, Australia, under which the unit owner may purchase a separate policy which will pay a mortgagor who elects not to permit restoration, up to the policy limits, the lesser of the mortgage principal balance or the amount of the loss, in exchange for an assignment to the insurance company of the mortgage, or so much thereof as equals the payment.\textsuperscript{84} The association will still be paid under its master policy, so restoration can be consummated. Since the risk to the casualty insurer is not that great,\textsuperscript{85} the cost of a separate mortgagee policy should not be excessive. Nevertheless, it does represent an additional expense for the unit owner.

Absent a solution such as has been adopted by New South Wales, the mortgagee may have to give up its option to apply the proceeds to the debt. Since this option is not often exercised, it would not seem that the loss, in and of itself, should cause very many lenders to decline making condominium mortgage loans.

B. No Other Insurance

Some casualty policies contain a clause permitting an endorsement which would prohibit the insured from obtaining other insurance without the consent of the insurer. While the use of such an endorsement is not de rigueur, a violation could render the insurance void. In condominiums there is a danger that the company may claim that the unit owner's coverage renders the master policy void or vice versa.\textsuperscript{86} The mortgagee's protection lies with the standard mortgagee clause which is deemed to create an "independent or separate contract . . . between the mortgagee and the insurer."\textsuperscript{87} Thus, the mortgagor's breach of the no-other-insurance clause should not render the policy void as against the mortgagee,\textsuperscript{88} provided, of course, that the insurer has no contract defense against the mortgagee\textsuperscript{89} and that the mortgagee clause

\textsuperscript{84} 1 Rohan & Reskin § 11.06[4], at 11-44.
\textsuperscript{85} Recovery can only be had if the mortgagee refuses to allow the proceeds to be applied to restoration. In such case, the restoration will nevertheless be accomplished through the master policy and the casualty insurer, after paying the mortgagor, will receive an assignment of the mortgage on the restored premises. Except for normal mortgage risks, the casualty insurer's exposure on this additional policy would seem generally limited to the difference between the mortgage interest rate and any higher current rate of return on its investments at the time of recovery.
\textsuperscript{86} In instances where one company is the insurer of both policies, it is possible that the principles of waiver or estoppel may be applied to prevent the company from asserting such a claim. See generally 18 G. Couch, Cyclopaedia of Insurance Law ch. 71 (2d ed. 1968).
\textsuperscript{87} 11 G. Couch, Cyclopaedia of Insurance Law § 42:694 (2d ed. 1963) (footnote omitted).
\textsuperscript{88} Queens Ins. Co. v. People's Union Sav. Bank, 50 F.2d 63 (3d Cir. 1931).
\textsuperscript{89} For example, it might be argued that knowledge by the mortgagee of a violation
is so written to cover "acts or negligence" of the association and of unit owners other than the mortgagor. The mortgagee clause, however, is not wholly satisfactory since the insurer generally reserves the right to cancel the policy subject to notice and a grace period for the mortgagee. To a spot mortgagee, notice of cancellation of the master policy does not really help that much.

C. Overlapping and Proration

When the association obtains a master policy and unit owners get their own individual coverage, the result may be overlapping insurance.\(^{90}\) This could result in recovery in excess of loss. The casualty insurers would then undoubtedly argue for proration, under which recovery, not in excess of the amount of the loss, would be shared by the insureds.\(^{91}\) Such a result would seem consistent with the theory that the principle of "indemnity has long been the cornerstone of property insurance law."\(^{92}\) It could be a disaster to the condominium. There might not be enough money for the association to restore the premises or not enough money for the individual owners to satisfy the mortgage debt. While there are certainly strong arguments against permitting proration,\(^{93}\) the result remains uncertain.

While some standard mortgagee clauses may be "contributing" in that they may contain specific language providing for proration with other insurance on the insured property,\(^{94}\) most such clauses do not provide for contribution and contain language to the effect that no "act" of the mortgagor shall invalidate the mortgagee's insurance.\(^{95}\) It has been held that this latter clause does not permit proration,\(^{96}\) although this view is not unanimous.\(^{97}\) As discussed above, in any event,


\(^{90}\) Both would seem to have an insurable interest since "[g]enerally speaking, a person has an insurable interest in property whenever he would profit by or gain some advantage by its continued existence and suffer some loss or disadvantage by its destruction. If he would sustain such a loss, it is immaterial whether he has, or has not, any title in, or lien upon, or possession of, the property itself." 3 G. COUCH, CYCLOPEDIA OF INSURANCE LAW § 24:13 (2d ed. 1960) (footnote omitted).

\(^{91}\) An illustration of a common proration clause can be found in the New York Standard Fire Policy, lines 86-89, as set forth in N.Y. INS. LAW § 168 (McKinney 1966), which states: "This Company shall not be liable for a greater proportion of any loss than the amount hereby insured shall bear to the whole insurance covering the property against the peril involved, whether collectible or not."


\(^{93}\) See 1 ROHAN & RESKIN § 11.04[2] for arguments on both sides.

\(^{94}\) See 3 W. FREEDMAN, RICHARDS ON INSURANCE 1789-97 (5th ed. 1952).


\(^{97}\) See Sun Ins. Office v. Varble, 103 Ky. 758, 46 S.W. 486 (1896), where the court held
the mortgagee clause does not prevent cancellation of the insurance. Thus, it would be advisable for the mortgagee to require that the master and individual policies provide that there be no proration. Again, the spot mortgagee may find it difficult to control what goes into the master policy and any bylaw requirements as to what goes into individual policies. An alternative solution for the association is to provide in the declaration that the unit owners assign to the association that part of any recovery they receive which represents a reduction of the association’s award. This may help the association but might not satisfy the mortgagee.

D. Subrogation

If recovery under the association’s policy is occasioned by damage caused by the negligence of a unit owner, or if there is a fire in a unit owner’s apartment caused by his negligence that does damage to a neighbor’s apartment, the association’s or the neighbor’s carrier, as the case may be, may claim the right to bring an action against the negligent unit owner through the right of subrogation.

The enabling statutes afford no protection against subrogation, and the condominium declarations generally do not contain a requirement that the policy contain a waiver of subrogation. “The insurer’s inclination to retain customer good will by voluntarily abandoning its rights under the subrogation clause cannot be relied upon to resolve this question in cases where a substantial loss is traceable to a financially sound or insured unit owner.” A statutory solution is, of course, the ideal way of meeting this problem. But until amending legislation is enacted, protection may not be afforded unless there is a requirement in the declaration that all policies held by the association or any unit owner contain a waiver of subrogation, and such waivers are forthcoming from the insurers. Alternatively, protection might be afforded by a waiver by the association and the unit owners to the extent permitted by law of the cause of action for negligence against each other. In that case, there would be nothing for the casualty company to be subrogated to.

that the mortgagee clause was limited by the general clause on contribution, citing Hartford Fire Ins. Co. v. Williams, 63 F. 925 (8th Cir. 1894), wherein, however, the contribution provision was contained in the mortgagee clause itself. The presence of a bylaw provision specifying the contents of unit policies raises the question of whether or not such a restriction would be consistent with condominium enabling legislation which grants to each unit owner the right to insure his own unit.

100 I Rohan & Reskin § 11.0513[3], at 11-33.
101 For typical language of such a waiver endorsement, see Even, supra note 81, at 215.
While this problem might be troublesome to the institutional mortgagee, it is not a crucial one. A large subrogation claim against the mortgagor or against the association might result in the eventual foreclosure of the mortgage but should not affect rights on foreclosure. When the mortgagee becomes the owner, it would be subject to insurers' subrogation rights, but liability for the foreclosing mortgagee's negligence is often covered adequately by its own insurance. Nevertheless, a solution to this problem would be desirable.

E. Conditions and Continuance

Most casualty policies contain conditions under which the insurer may be relieved of liability if the insured violates certain provisions of the policy. The most obvious is the failure to pay the premium. Others include such breaches as arson, increase in hazard, and failure to report losses.

The problem of breach of conditions is faced by all mortgagees. But under the standard mortgagee clause, a breach will not invalidate the insurance as against the mortgagee. If the insurance is to be cancelled because of a breach of conditions, the mortgagee will receive prior notice and have an opportunity to obtain substitute insurance, normally at the mortgagor's expense.

With a condominium, the possibility that conditions will be violated increases manyfold, and if the insurance is cancelled the spot mortgagee is not normally in a position to insure the entire condominium to protect its investment. One solution is a clause in the policy stating that there will be no cancellation of the master policy in the event of a breach by a unit owner. With such a clause the insurer would still be in a position to cancel with respect to the unit insurance, but this would not put the mortgagee in any worse position than in the normal mortgage situation.

Donald L. Anderson suggests\(^1\) that it may be possible to obtain a clause in the master policy that the insurance will be renewed (and, presumably, not terminated during its term) on partial default in payment of premium, due to default by some unit owners, if at least 60 percent of the premium is paid. The difficulty for the spot mortgagee, as always, is being able to obtain and continue such protective clauses in the master policy. Here, again, a statutory amendment covering insurance could require such a clause in all master policies.

From the foregoing discussion of insurance problems, it would

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seem that what is needed is a comprehensive statutory amendment which would specify the type of insurance required for each condominium—insurance which would protect the interests of the association, the unit owner, and the mortgagee, and which is realistic enough to specify insurance which can and will be written by the casualty insurers. For example, a master policy could be required with supplementary group coverage for unit owners, containing waivers of both subrogation and proration, and protection against termination. Elimination of all problems for the mortgagee is, of course, wishful thinking. In balancing interests, undoubtedly the mortgagee will have to sacrifice some of its rights, such as the right to apply the proceeds to the debt. But if the statute specifies that an insurance trustee be appointed to apply the proceeds to restoration and provision is made for sufficient coverage to make the repairs, this loss would seem to be one that can be accepted by the mortgagee.

Fortunately, much more attention has been paid recently to the insurance problem of the condominium, and casualty insurers seem to be working toward devising forms of policies to meet the needs of condominiums.103 However, until a comprehensive statutory clarification is accomplished, casualty insurance will continue to present numerous problems for the mortgagee and certain risks will have to be taken, especially where the mortgagee's loans do not cover a majority of the units in the condominium.

**The Single Mortgagee**

In the absence of a statutory solution, many of the problems discussed above may be mitigated, or even avoided entirely, if the mortgagee holds mortgages on all or the vast majority of units.104 Of course, the mortgagee, having made all or most of the mortgage loans on any condominium, cannot be certain that these mortgages will not be

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103 See, e.g., Kenyon, *Insuring the Condominium*, 19 PRAC. LAW, Nov. 1973 at 13, where a new type of master policy for the condominium is discussed under which the problems covered above could be reduced or eliminated. See also *The Allstate Insurance Companies' new Condominium Owners Policy* which would provide personal property and liability coverage in the unit and supplement the condominium association's insurance on the common areas with “loss assessment coverage.” Ins. News Digest, Aug. 20, 1973, at 4; J. of Commerce, Aug. 22, 1973, at 2. The Cotton Belt Insurance Company was the first company to offer insurance for condominium officers and board members. 1 CONDOMINIUM REP. NO. 7, Aug. 1973, at 3.

104 For example, a mortgagee of most of the units will probably not find himself the owner of only one or a few units in a condominium where many other owners are in default in common area payments. Also, through properly drafted default provisions in the mortgages, the mortgagee can make certain that adequate casualty and liability coverage is maintained.
refinanced with other lenders or that upon sale of any unit the new owner may procure financing elsewhere. While this may result in some attrition, it should not present a serious obstacle as will be seen from the discussion below.\footnote{See discussion of "The Lock-In" in text accompanying notes 129-30 infra.}

There are, however, several reasons why the institutional lender may hesitate to take any action leading to its becoming the single mortgagee for all the units in the condominium.

A. Antitrust

Manuel M. Gorman, then Assistant Counsel of the Life Insurance Association of America (LIAA), in his article, Life Insurance and the Anti-Trust Laws,\footnote{6 J. AM. Soc’Y C.L.U. 20, 29-30 (1951). Mr. Gorman had been chief of the Special Litigation Section of the U.S. Department of Justice before joining the LIAA, where he is now Vice-President and General Counsel.} recalled the statement of Louis D. Brandeis\footnote{Later Mr. Justice Brandeis.} before a congressional committee in 1913. Brandeis said that when businessmen came to him for advice on the antitrust laws, he warned that he could not advise them how to walk precisely on the edge of a cliff without falling off. But, he said, he could show them a path a few yards back from the edge where they could walk with safety. Brandeis' statement would seem applicable when it comes to attempts by the mortgagee to garner all the loans in a particular condominium. If a mortgagee should tell the developer that he will make the construction loan\footnote{In the past, banks have been the major source of construction financing, and the life insurance company has tended to avoid construction lending, perhaps because of the inherent problems involved therein. However, in recent years, especially in connection with equity joint ventures in real estate, insurers have, with increasing frequency, made or participated in construction loans. See Roegge, Talbot & Zinman, supra note 5, at 588.} only on condition that he get all the long-term unit mortgages, this might under some circumstances be construed as something similar to a tying arrangement.\footnote{Cf. Fortner Enterprises, Inc. v. United States Steel Corp., 394 U.S. 495 (1969) (Court held for petitioner, who claimed he was required to erect defendant's prefabricated houses as a condition to obtaining loans); Fry v. John Hancock Mut. Ins. Co., 355 F. Supp. 1151 (N.D. Tex. 1973) (court, finding the McCarran Act inapplicable, see note 113 and accompanying text infra, refused to dismiss a complaint under the Sherman Act which alleged a tying arrangement that plaintiff was required to purchase an irrigation system and/or life insurance as a prerequisite to obtaining a farm loan); Stravides v. Mellon Nat'l Bank & Trust Co., 353 F. Supp. 1072 (W.D. Pa. 1973) (court refused to dismiss complaint that alleged a tying arrangement in that mortgagors were required to keep escrow accounts for taxes and insurance with defendant institutions as a condition to obtaining mortgage financing). Thomas H. Fegan, Associate General Counsel of Equitable Life Assurance Society, stated in a PLI program that "the opinion exists in some quarters that this practice [builder pressure on the purchaser to accept a mortgage from the construction lender or to accept the release fee] may well be frowned on by} And where the institution is not involved in
the construction financing, but agrees to do the long term financing only on condition that it be guaranteed all or a substantial portion of the loans, a rather theoretical argument might lead to construing this as an unlawful exclusive dealing arrangement under certain circumstances.\textsuperscript{110}

There are many arguments against the above actions constituting antitrust violations. First, section 3 of the Clayton Act, which specifically proscribes exclusive dealing and tie-in arrangements, would not appear applicable to loans of money, since by its terms it deals only with sales or leases of commodities.\textsuperscript{111} Thus, the conduct would have to be attacked as an unreasonable restraint of trade under section 1 of the Sherman Antitrust Act or possibly section 5 of the Federal Trade Commission Act.\textsuperscript{112} Second, for the insurance company lender, it may be possible to argue that the Sherman Antitrust Act is inapplicable under the provisions of the McCarran Act\textsuperscript{113} which provides, in effect, that the Sherman Antitrust Act, the Clayton Act and the Federal Trade Commission Act are inapplicable, with certain exceptions, "to the business of insurance" to the extent that such business is regulated by state law.\textsuperscript{114} Third, depending on the facts and details of the locality and the particular condominium or condominiums involved, it would seem that such conduct should not normally constitute a restraint on trade, or, even if the conduct were held to constitute a restraint on trade, it would appear difficult for the plaintiff to argue that such a restraint is unreasonable in light of the strong nonmonopolistic business reasons for which such action has been taken.

\textsuperscript{110} See United States v. Charg-It, Inc., 1960 CCH Trade Cas. ¶ 69,870 (D. Md.), where the court enjoined defendant from enforcing central credit service plan provisions having the effect of limiting the use of other credit service plans. Cf. United States v. General Motors Corp., 121 F.2d 376 (7th Cir. 1941).

\textsuperscript{111} "It shall be unlawful for any person engaged in commerce . . . to lease or make a sale or contract for sale of goods, wares, merchandise, machinery, supplies, or other commodities . . . on the condition, agreement, or understanding that the lessee or purchaser thereof shall not use or deal in the goods, wares, merchandise, machinery, supplies, or other commodities of a competitor . . . where the effect . . . may be to substantially lessen competition or tend to create a monopoly in any line of commerce." Clayton Act § 3, 15 U.S.C. § 14 (1970). See United States v. Investors Diversified Servs., 102 F. Supp. 645 (D. Minn. 1951).

\textsuperscript{112} "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. . . ." Sherman Antitrust Act § 1, 15 U.S.C. § 1 (1970). The Federal Trade Commission Act § 5 states that "unfair methods of competition in commerce, and unfair or deceptive acts or practices in commerce, are declared unlawful." 15 U.S.C. § 45 (1970).


\textsuperscript{114} Id. § 1012. The exceptions are boycott, coercion and intimidation.
To the author's knowledge, the common practice in normal subdivision development for the developer to arrange financing and include some of the costs thereof (e.g., legal fees, title insurance) in the cost of the house, leaving the buyer the option of obtaining his own financing at some additional expense, has, justifiably, not been attacked.

Notwithstanding all of the foregoing, most lenders would want to study the facts and law very carefully before taking any steps in this area.

B. Liability

If a mortgagee is the sole mortgagee, or if loans by a specific mortgagee are encouraged or offered as part of the sale "package" by the developer, the mortgagee will seem to become rather closely involved in the condominium development. The credit of the developer will be examined by the mortgagee. The plans and specifications may be subject to its approval. Its architects may periodically inspect the premises. The presence of the mortgagee may be felt by the unit purchasers, who may come to rely, however improperly, on his judgment regardless of what exculpatory language is found in the agreements. And when something goes wrong, it may be possible that they will attempt to look to the mortgagee for recovery. This raises the question of whether the mortgagee can be held liable for the negligence of the builder.

When the scale fell on Mrs. Palsgraf in that Long Island Railroad station — due to the explosion of a parcel containing fireworks dropped by a man at the other end of the platform while being assisted in boarding the train by railroad employees — Chief Judge Cardozo of the New York Court of Appeals held that the railroad was not liable to Mrs. Palsgraf because it was not within the range of reasonable apprehension that the parcel would be a danger to others in the station. The court said: "The risk reasonably to be perceived defines the duty to be obeyed, and risk imports relation; it is risk to another or to others within the range of apprehension. . . ."116

While this doctrine of "duty" avoided liability for the Long Island Railroad, it was the same doctrine which appears to have been the basis of Judge Traynor's decision finding liability in Connor v. Great Western Savings & Loan Association.117 Great Western was the mortgagee for a housing development and was rather closely associated with the developer, although the court held that no joint venture was in-

116 Id. at 344, 162 N.E. at 100 (citations omitted).
The agreement provided that Great Western would commit itself to make a land acquisition loan and in return would be given the right to make the construction loan and receive a "right of first refusal" on the long-term loans made to the purchasers of homes. In order to protect its interest, Great Western employed a geologist to check on the available quantity of water. As part of the "land warehousing" plan, Great Western actually took title to the land for a period of time. Great Western knew that the developer was highly undercapitalized and in weak financial condition. Having required plans and specifications, Great Western did not examine the foundation plans and made no recommendations as to the design or construction of the houses, although its inspectors visited the property weekly to verify that the building plans were being followed and that money was disbursed only for work completed. When the roof fell in, or, in this case, the foundations, the court held, inter alia, that Great Western had been negligent; that its intimate involvement with the construction "took on ramifications beyond the domain of the usual money lender;" that it knew or should have known of the soil and foundation problems; and that it could have reasonably foreseen the risk of harm to buyers of homes normally ill-equipped to discern the structural defects. It owed and breached a "duty [of] . . . reasonable care to prevent the construction and sale of seriously defective homes" and was held liable.

By stating that this lender went beyond the usual money lender's domain, the court implies that the normal mortgagee, acting within his usual domain, would not be subject to liability. What the "usual domain" of a mortgagee is, however, may be subject to some question.

118 Id. at 863, 447 P.2d at 615, 73 Cal. Rptr. at 375. See discussion in text accompanying notes 197-201 infra.
119 Id. at 858, 447 P.2d at 612, 73 Cal. Rptr. at 372. If a buyer wished to obtain other financing, Great Western had 10 days to meet the other terms. If Great Western, having met the other terms, still did not get the loan, the developer agreed to pay Great Western the "fees and interest" obtained by the other lender in connection with the loan. Id. at 861, 447 P.2d at 614, 73 Cal. Rptr. at 374.
120 It should be noted that while the issue did not come before the court, there justifiably does not appear to have been any contention that the right of first refusal under the circumstances of the case constituted an unreasonable restraint of trade in violation of the Sherman Act. See note 109 and accompanying text supra.
121 The arrangement . . . was an early example of . . . 'land warehousing.' Under such an arrangement, a financial institution holds land for a developer until he is ready to use it. Unlike a normal bailee of personal property, however, the institution retains title to the property as well as the right to possession.
122 Id. at 860-62, 447 P.2d at 615-15, 73 Cal. Rptr. at 373-75.
123 Id. at 864, 447 P.2d at 616, 73 Cal. Rptr. at 376.
124 Id. at 864-67, 447 P.2d at 616-18, 73 Cal. Rptr. at 376-78.
125 Id. at 867, 447 P.2d at 618, 73 Cal. Rptr. at 378.
In any case, the result in *Great Western* would probably not occur now in California because of the adoption of a clarifying statute,¹²⁶ and the decision has not been followed or has been properly distinguished in other cases.¹²⁷ But the danger remains. In a condominium situation, where a lender is making all or a vast majority of the long term unit loans, and may also be directly involved in the construction lending, it is possible that these questions may arise again.¹²⁸

C. The Lock-In

Some executives of lenders that have engaged in the financing of condominiums are not at all happy that their institutions hold most of the mortgages for particular condominiums. They have complained that when they have made all or most of the loans in a condominium, other lenders shy away from refinancing or making loans to second generation purchasers of condominium units. When prospective purchasers, or owners seeking refinancing, go to lenders, they are told that it would not be worth the lender’s while to examine all the condominium documents and take the risks associated with being a spot mortgagee for the size of the proposed mortgage investment.¹²⁹

In these circumstances, the original institution may discover that

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¹²⁶ Cal. Civ. Code § 3434 (West 1970) provides:

A lender who makes a loan of money, the proceeds of which are used or may be used by the borrower to finance the design, manufacture, construction, repair, modification or improvement of real or personal property for sale or lease to others, shall not be held liable to third persons for any loss or damage occasioned by any defect in the real or personal property so designed, manufactured, constructed, repaired, modified or improved or for any loss or damage resulting from the failure of the borrower to use due care in the design, manufacture, construction, repair, modification or improvement of such real or personal property, unless such loss or damage is a result of an act of the lender outside the scope of the activities of a lender of money or unless the lender has been a party to misrepresentations with respect to such real or personal property.

It should be noted, however, that the *Great Western* court found the lender’s involvement “beyond the domain of the usual money lender,” see text accompanying note 123 supra, which language is similar to “outside the scope of the activities of a lender of money” in the above quoted statute.


¹²⁸ Traditionally, mortgage lenders have taken the position that they owed no duty to borrowers as to the value or condition of the mortgaged security. Any inspections of the property made by the lender were solely for the benefit of the lender. We may be entering into a new era insofar as that relationship is concerned.

Fegan, supra note 83, at 287.

¹²⁹ The purchaser is in no position to shop. The feeling is that the task of examining all of the documentation of a condominium project is too time-consuming to justify another lending institution undertaking it for the purpose of processing one or two loans.

*Id.* at 254.
only it will be able to make successive loans, and all kinds of moral and other pressures may force it to do so, even when it would prefer not to. Thus, this side of the coin is not much shinier than the other, and the mortgagee may think twice before it becomes too heavily involved in any particular condominium development. Some solution to this problem, however, may be in the making. Recently, the New York State Home Builders' Association, concerned by the reluctance of banks to become spot mortgagees on condominiums, began the preparation of model condominium documents which, once approved by the mortgagee, need not be restudied with each new condominium spot mortgage made. However, upon learning that the New York Attorney General's office was also preparing model forms, the committee formed by the Home Builders' Association, suspended drafting activities awaiting the printing of the Attorney General's forms which should be released shortly. There is no question that model forms, if they achieve wide acceptance, combined with statutory amendment to correct some of the problems herein discussed, would go a long way to facilitate and encourage spot mortgage investments in condominiums.

THE INSTITUTIONAL INVESTOR AS CONDOMINIUM SPONSOR

In connection with joint ventures or other equity investments, the institutional investor may receive proposals involving the construction and sale of condominium units perhaps by the institution itself, but most likely as a partner or venturer with a real estate developer.

If the institution agrees to undertake such a development, it will become a sponsor of a condominium, subject to all the problems generally faced by developers in this area, as well as some which affect only the institution. In this part of the paper, an attempt will be made to cover a few of the major problem areas of current interest with a view to aiding the institutional investor in making a more intelligent decision in any particular fact situation as to whether to become a condominium sponsor.

*Investment Law Limitations*

Statutory limitations on investments of institutional lenders may create roadblocks to institutional sponsorship of condominiums. Such limitations on insurance company investments in real estate are illustrative of the problems faced by many types of institutions in this area.

After World War II, many states amended their insurance laws to

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130 Interview with William Parry, Esquire, whose office participated in the drafting of the New York State Home Builders' Association forms.
permit investment in real estate for the production of income. New York added paragraph (h) to section 81(7) in 1946 and provided that if the property was not income producing at the time it was acquired, it could nevertheless be purchased if there were an existing program to make the property income producing. New Jersey authorized ownership of real estate for the production of income as early as 1945 and Massachusetts in 1947. By 1957, David J. Bannon, Jr., in a paper for The Association of Life Insurance Counsel was able to state:

Apart from constitutional considerations, the privilege of ownership of income producing real property is rapidly achieving universal acceptance. Where required, permissive legislation has taken place on a country-wide scale with real obstacles remaining only in South Dakota and Texas but favorable legislation is even now reported pending in the latter State.

A constitutional problem was settled in Michigan in 1963 by amendment to its constitution and implementing legislation. In 1966, South Dakota came into the fold and, in 1967, Texas permitted ownership of income producing real estate with, however, some significant limitations.

The unanswered question in this legislation with respect to condominium sponsorship, however, is whether the purchase of land for improvement and sale is an investment for the production of income within the meaning of the applicable laws. On the negative side, the argument is that the purchase of land for sale at a profit is a speculation whether or not the institution invests money in the land by improving the real estate prior to sale.

On the other hand, it would seem that the line between speculation and investment should not be drawn in this manner. Why should

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135 Id. at 455. For a short review of the history of laws with respect to life insurance company investments in income producing real property, see Roegge, Talbot & Zinman, supra note 5, at 579-83.
a purchase of land for the purpose of improvement and sale be considered a speculation? Why is "profit" not "income"? While it is possible that the purchase of raw land to be held with the hope of an increased price on resale could under many circumstances be considered a mere speculation, improvement of raw land with buildings or even the conversion of raw land into building lots, for the purpose of sale, would seem to be a method of producing income and no more a speculation than the building of improvements on raw land for the purpose of leasing. Since the investment is recovered once the property is sold there may, in fact, be less of a risk when a building is built for sale than when it is built for lease, for while the rental market may be good at the time the building is constructed, it may be bad when the initial leases expire and new tenants have to be found. This reasoning has generally been adopted by the New York Insurance Department in a recent information letter.\textsuperscript{139}

In light of the dramatic growth in the use of condominiums throughout the nation,\textsuperscript{140} it would appear that such rulings should be forthcoming in other states having similar legislative or constitutional authorization for investment in real estate for the production of income, and it is understood that there have been other private rulings to this effect. However, until the appropriate department having jurisdiction has spoken, institutional investors must act with caution.

\textit{Federal and State Regulation}

Once the hurdle of state investment laws and regulations is passed, the institutional sponsor of a condominium is faced with all the problems normally associated with condominium development, a major one of which is compliance with any applicable laws and regulations including federal securities and state blue sky laws. Perhaps the problems of the large institutions are even greater than those of the normal sponsor. Generally, the institutional investor will not build and sell the condominium on its own. More likely, it will act with a developer-partner, who will be in charge of the day-to-day operation of the venture, consulting with the institution only in cases involving major decisions.\textsuperscript{141}

In this context the institution is concerned that its partner may, without

\textsuperscript{139} Letter from the New York Insurance Department to William F. Leahy, Vice President, Metropolitan Life Insurance Company, May 7, 1971.

\textsuperscript{140} See note 4 supra.

authorization, violate some requirement of applicable law and that it might be argued that the institution is liable under principles of agency or under the "controlling persons" sections of the 1933 and 1934 federal securities acts.\textsuperscript{142}

It is still not completely clear to what extent federal securities laws are applicable to condominiums, which are generally sold as real estate for the purchaser's own use, and not as securities.\textsuperscript{143} However, for some time there has been concern that certain types of condominium offerings may nevertheless be subject to federal regulation,\textsuperscript{144} and in January 1973, the Securities and Exchange Commission (SEC) confirmed this fear when it issued Securities Act Release No. 5347.\textsuperscript{145} Said the Commission: "The SEC notes that certain offers and sales of condominium units . . . may involve the offering of securities within the meaning of the Securities Act and the Exchange Act. In addition, persons engaged in the business of buying or selling such securities may be required to register as brokers or dealers under the Exchange Act."\textsuperscript{146}

What are these "certain offers and sales of condominium units?" The SEC noted that the ordinary sale of a condominium is the sale of an interest in real estate and that the "offer of real estate as such, without any collateral arrangements with the seller or others, does not involve the offer of a security."\textsuperscript{147} However, citing \textit{SEC v. W. J. Howey Co.},\textsuperscript{148} a 1946 Supreme Court decision involving the sale and operation of orange groves, the reasoning of which case could be applicable to condominiums,\textsuperscript{149} the SEC stated that where there is a rental pool or other such arrangement\textsuperscript{150} offered with the condominium unit, it is possible


\textsuperscript{144} See generally JA Rohan & Reskin §§ 18.01-.05.


\textsuperscript{146} SEC Release No. 5347, \textit{supra} note 145, at 82,535-36.

\textsuperscript{147} Id. at 82,536.

\textsuperscript{148} 328 U.S. 293 (1946).

\textsuperscript{149} SEC Release No. 5347, \textit{supra} note 145, at 82,539.

\textsuperscript{150} Typically, the rental pool is a device whereby the promoter or a third party undertakes to rent the unit on behalf of the actual owner during that period of time when the unit is not in use by the owner. The rents received and the expenses attributable to rental of all the units in the project are combined and the individual owner receives a ratable share of the rental proceeds regardless of whether his individual unit was actually rented.

\textit{Id.}
that a form of investment contract is being offered in that the unit purchaser might be led to expect a return on his investment from the managerial efforts and expertise of others.\textsuperscript{151} The release makes it clear that the following \textit{will} cause the offering to be viewed as an offering of securities in the form of investment contracts:

(1) If the condominiums, with any rental arrangement or similar service, are offered and sold with emphasis on the economic benefits to the purchaser to be derived from the manager's expertise in renting the units.\textsuperscript{152}

(2) If there is an offering of participation in a rental pool arrangement. (It could be argued from this that if an offered service fits within the definition of a rental pool, an offering of securities might be involved regardless of whether emphasis was placed on the economic benefits to be derived from the manager's expertise.)\textsuperscript{153}

(3) If the owner is materially restricted in his occupancy or rental of his unit by virtue of the rental or similar arrangement. (Examples given are requirements that the unit owner hold the unit available for rental for any part of the year or that he use an exclusive rental agent.)\textsuperscript{154}

The release goes on to state that where commercial facilities are a part of the common elements of a residential project, "no registration\textsuperscript{155} would be required under the investment contract theory" if the income is used "only to offset common area expenses" and the facilities are "incidental to the project as a whole and are not established as a primary income source for the individual owners. . . ."\textsuperscript{156} However,
this leaves some unanswered questions.\textsuperscript{157} Since the exemption from registration is specifically limited to the "investment contract theory," is the SEC hinting that there are other theories on the basis of which the securities laws may be applicable which may be revealed at a later date? Do such commercial facilities make the offering an offering of a security under the investment contract theory and subject to all requirements of the federal security laws other than registration?\textsuperscript{158} Why is the exemption limited to "residential" projects and what kind of project is it when there are both residential and commercial condominium units? What happens if the commercial facilities are designed only to offset common area expenses, but, as it turns out in practice, they make a profit in addition? When are commercial facilities only "incidental" to the condominium and not established as a "primary income source" for the owners? In the light of questions such as these, it may be that this "exemption" for commercial facilities is really a "warning."

The release concludes with a caveat:\textsuperscript{159}

The Commission, therefore would like to remind those engaged in the offering of condominiums or other interests in real estate with similar features that there may be situations, not referred to in this release, in which the offering of the interests constitutes an offering of securities. Whether an offering of securities is involved necessarily depends on the facts and circumstances of each particular case. The staff of the Commission will be available to respond to written inquiries on such matters.\textsuperscript{160}

In addition to the SEC, a condominium sponsor must deal with any applicable state blue sky regulatory body. Several states require


\textsuperscript{158} A recent decision involving Co-Op City, a large cooperative in the Bronx, New York City, held that the offering of stock of a cooperative was the offering of stock and an investment contract under the securities laws. Forman v. Community Services, Inc., 500 F.2d 1246 (2d Cir. 1974), rev\textsuperscript{d}g 366 F. Supp. 1117 (S.D.N.Y. 1973). Notwithstanding the fact that tenant shareholders were prevented from making any profit on the resale of the stock, the court said, they had an expectation of income, \textit{inter alia}, because they would "share in the income from the leasing of retail establishments, office space, parking, and other commercial enterprises on the premises." 500 F.2d at 1254. It is assumed that such income was used only to offset common area expense. \textit{See} 1050 Tenants Corp. v. Jakobson, 365 F. Supp. 1171 (S.D.N.Y. 1973), aff\textsuperscript{d}, 503 F.2d 1375 (2d Cir. 1974), where the court found that shares in a cooperative housing corporation were "securities" or "investment contracts." In this case there was no restriction on resale price.

\textsuperscript{159} SEC Release No. 5347, \textit{supra} note 145, at 82,540.

\textsuperscript{160} For example, see SEC Staff Reply, The Innisfree Corp. (April 5, 1973), \textit{[1973 Transfer Binder] CCH Fed. Sec. L. Rep. \textsuperscript{\$} 79,398}. 
registration of all condominium projects whether or not they involve a rental pool or other such arrangement. The New York requirements are rather comprehensive. Under regulations issued by the New York Attorney General pursuant to statutory authorization, an offering statement must be filed in connection with all condominiums, whether or not the offering amounts to the offering of a "security." The offering statement must include an "offering plan" containing "a full and fair summary of all the material facts relating to the offering." The required contents of the offering plan are spelled out in detail, and the regulations require information on 44 items in addition to those required by statute. The items required by the regulations include details on assessment for real estate tax purposes; restrictions on alienation, sale, lease, etc.; a detailed description of the nature of expenditures for operation and management; insurance required to be provided; relevant details concerning the condominium regime; and "[e]stimates of the aggregated common receipts and expenditures for the first year of operations and estimates of the common charges and other expenditures for each individual condominium interest for such period, together with the qualifications of the party making such estimates." One wonders whether these security style disclosure requirements make sense when applied to condominiums. Does the voluminous prospectus inform the purchaser, or does it hide from the purchaser the relevant facts in a sea of detail? Whatever the advisability of the disclosure approach to condominium regulation, it is being employed, and as can be seen from just this abbreviated list of New York disclosure requirements, there is plenty of room for error and plenty of room for lawsuits concerning the errors.

For example, in what, if successful, may become the largest condominium in the world, the owners of Parkchester, in their attempt

161 See, e.g., HAWAII REV. STAT. § 514-36 (1968); N.Y. GEN. BUS. LAW § 352-e(1)(a) (McKinney Supp. 1972); VA. CODE ANN. § 55-79.88 (Supp. 1974) (exemption available for, inter alia, "commercial, industrial, or other nonresidential" condominiums, id. § 55-79.87). See generally I ROHAN & RESKIN § 3.05.
166 Id. 19.2.
167 Id. For a thorough analysis of New York condominium registration, see Levine, Registering A Condominium in New York, 19 N.Y.L.F. 495 (1974).
168 Parkchester, located in the easterly portion of the Bronx in New York City, was acquired and constructed in the late 1930's and early 1940's by Metropolitan Life Insurance Company. Sold to a group headed by Harry B. Helmsley in 1968, Parkchester houses over 12,000 families.
to condominiumize the north quadrant thereof, were sued on the ground that the offering plan is alleged not to have contained a full and fair summary of the material facts relating to the offering, as required by the Attorney General's regulations. The suit against the owners was dismissed on a motion for summary judgment, but a companion suit against the Attorney General for approving the prospectus is still pending before the New York Court of Appeals.

In what is probably the largest cooperative in the world, Co-Op City, the sponsors, in an action brought under the federal securities laws, are now being sued by the cooperative owners for, inter alia, alleged errors concerning construction costs and carrying charges contained in an information bulletin distributed to prospective purchasers.

If federal securities and state blue sky laws were not enough, condominium sponsors must also now contend under certain circumstances with the U.S. Department of Housing and Urban Development under the Interstate Land Sales Full Disclosure Act of 1968, notwithstand-

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169 See note 202 infra.
172 Co-Op City is located in Baychester, a northerly section of The Bronx in New York City, former site of the ill-fated Freedomland Amusement Park. It houses over 15,000 families.
174 One of the allegations is that the information bulletin, as amended, estimated, inter alia, construction costs at $258,507,750 pursuant to a guaranteed cost lump sum construction contract, but that the contract was successively amended and the construction costs successively increased by $81,997,250 to a total of over $340,500,000. See Amended Complaint at 10-13, 17-20.
175 15 U.S.C. § 1701 et seq. (1971). The Act is intended to deter interstate land sales made through material misrepresentations relating to the property. Its provisions require developers selling or leasing fifty or more unimproved lots under a common promotional plan to prepare two disclosure statements. The first, called “the statement of record,” is a registration statement which must be filed with the Secretary of Housing and Urban Development (HUD). The second is a “property report” which must be submitted to the purchaser prior to sale. Id. § 1703(a)(1). The required disclosures range from a legal description of the land to a statement of the present condition of access to the subdivision. See id. § 1705. If the promoter fails to supply the purchaser with a property report in advance of the signing of the contract, the buyer may rescind. Furthermore, the report must be in the hands of the purchaser at least 48 hours prior to his signing or the
ing the fact that the Act in section 1702(a)(3) exempts from registration thereunder, \textit{inter alia}, sales of existing buildings and sales of land under contracts obligating sellers to erect buildings on the land within two years. The problem for the condominium sponsor is determining when the condominium is completed for the purposes of this regulation.

The Office of Interstate Land Sales Registration has issued guidelines interpreting the exemption\textsuperscript{176} which require a contract obligating the seller to erect a building or condominium unit within the two year period subject only to delays legally supportable in the jurisdiction as impossible of performance for reasons beyond the developer's control. For primary residence condominiums in metropolitan areas, the contract is deemed completed when the condominium unit is ready for occupancy, but "in the case of sale of condominiums in which the promotion of the common facilities is the primary inducement to purchase" (as may be the case in certain recreational developments), the expected completion of these common facilities must be concomitant with the expected completion of the condominium unit.\textsuperscript{177}

In addition to the exemption for finished projects, avoidance of registration is also possible if each unit purchaser makes a personal on-site inspection of the property prior to the signing of his contract.\textsuperscript{178} Such all-inclusive inspection may be next to impossible for "hinter-land" condominiums advertised over long distances, but it may provide

\begin{itemize}
  \item Buyer will have a right of rescission for three business days after signing. \textit{Id.} § 1703(b), as amended, Pub. L. No. 93-383, § 812(c)(1)(A) (Aug. 22, 1974).
  \item Noncompliance with the Act exposes the sponsor to numerous liabilities. For example, he may be sued for damages by "any person acquiring a lot in the subdivision" for an "untrue statement of a material fact or omission" in the statement of record, and the original purchaser has a cause of action for misrepresentations in the property report. \textit{Id.} § 1709(a), (b). The Secretary of HUD may enjoin the sale of lots for noncompliance with the Act, \textit{id.} § 1714, and there are criminal penalties for willful violations. \textit{Id.} § 1717.
  \item 39 Fed. Reg. 7824 (1974). The Office of Interstate Land Sales Registration (OILSR) contends that a condominium project is "equivalent to a subdivision, each unit being a lot." 38 Fed. Reg. 23,866 (1973). Opposition to registration of condominium developments has been based on the argument that condominiums are the equivalent of houses, the sale of which was not intended to be covered by the Act. OILSR counters, "[T]he right to condominium space is a form of ownership, not a structural description." \textit{Id.}
  \item See 15 U.S.C. § 1702(a)(10) (1971). This exemption also requires that at the time of sale the real estate must be free of all liens, encumbrances, and adverse claims. \textit{Id.} Whereas the other statutory exemptions require no formal approval, when on-site inspection is employed, the promoter must, \textit{inter alia}, submit an exemption claim to the Secretary of HUD and must present the purchaser with a statement disclosing reservations and restrictions, taxes, and assessments. See 38 Fed. Reg. 23,876-77 (1973). It should be noted that the latter items must merely be disclosed to the purchaser; they do not necessarily constitute "liens, encumbrances, and adverse claims" which would disqualify the sale from exemption. \textit{Id.} at 23,877. There are additional minor exemptions, both in the Act and the regulations, which should not be overlooked. See 15 U.S.C. § 1702 (1971); 38 Fed. Reg. 23,876-77 (1973).
\end{itemize}
a viable alternative for metropolitan projects intended for a more local market. It has also been suggested that metropolitan condominiums are less likely than their rural counterparts to require registration because the developer will probably be able to deliver a completed unit within two years after the sale.\textsuperscript{179} Notwithstanding the exemptions, it is possible under these regulations that many phase developments might be subject to the Act.

Not to be left out, the Federal Reserve Board, charged with the responsibility of implementing the Truth-in-Lending Act,\textsuperscript{180} formulated Regulation Z\textsuperscript{181} and has explained how that regulation might be applicable to condominium sales.\textsuperscript{182} Under that interpretation, a sponsor can be brought within the Act's coverage: 1) if he personally extends credit to the purchaser, imposing a finance charge for the credit; 2) if he negotiates an installment sale contract; or 3) if he "arranges for the extension of credit," such as by obtaining a commitment from a mortgage lender to provide the buyer's financing.\textsuperscript{183}

In addition to complying with the foregoing, the sponsor must also satisfy various agencies that the project will have no adverse effect on the environment. In some states statutory requirements are very comprehensive.\textsuperscript{184}

\textsuperscript{179} See 1 CONDOMINIUM REP., Nov. 1973, at 2.
\textsuperscript{181} 12 C.F.R. § 226 (1973).
\textsuperscript{183} Id.
\textsuperscript{184} In California, for example, there are special acts designed to protect the environment from ill-conceived building projects. Under the Environmental Quality Act of 1970, CAL. PUB. RESOURCES CODE § 27,000 \textit{et seq.} (West Supp. 1973), local planning agencies must prepare "environmental impact" reports prior to the issuance of certain use and building permits. In Friends of Mammoth v. Board of Supervisors, 8 Cal. 3d 247, 502 P.2d 1049, 104 Cal. Rptr. 761 (1972), the developer secured a bona fide building permit from the planning commission, only to have the project blocked because of the commission's failure to prepare a report considering "whether the proposed condominium construction 'may have a significant effect on the environment.'" Id. at 252, 502 P.2d at 1059, 104 Cal. Rptr. at 771. Although the burden of preparing the environmental impact report is on the local planning agency, the agency may demand the submission of pertinent data and information from the developer. See CAL. PUB. RESOURCES CODE § 21,160 (West Supp. 1973).

Under the Coastal Zone Conservation Act of 1972, CAL. PUB. RESOURCES CODE § 21,160 (West Supp. 1973), a developer of coastline property must secure permission to build from a regional state agency charged with the duty of considering the project's effect on the coastal environment. One such agency was unsuccessful in restraining an allegedly un-
Thus, becoming a sponsor of a condominium development is not only as difficult, complicated, and risky as entering into any joint venture, but it is also more troublesome because of the added complications of federal and state regulation. Such an undertaking should not be commenced without deliberate and careful consideration of the numerous problems involved.

**The Expanding Condominium**

For obvious business considerations many large condominium projects are built in phases. The institution, perhaps because it is often capable of investing larger sums of money than other lenders, may be involved in many of these “phase” transactions.

In the phase development, the percentage interests of the unit owners in the common areas will fluctuate during the period the various phases are being constructed and sold. For example, assume a three phase condominium of 200 units each. The first phase is built along with a swimming pool, golf course and other facilities intended for eventual use by all three phases. When phase one is completed, each unit owner will have a 1/200 interest in these common facilities; when phase two is completed, a 1/400 interest; and when phase three is completed, a 1/600 interest. The problem is that much of the enabling legislation either severely restricts or will not permit these fluctuations.

This legislation often requires that the common facilities be described with particularity in the declaration and that the common interest appurtenant to each unit be shown by an appropriate percentage as of the date of the declaration and have a permanent char-

185 The prudent developer will generally build his condominium project in phases where he has not obtained a substantial amount of advance sales. Phasing provides the developer with an opportunity to test the condominium market rather than to begin construction of the entire project and thereby assume that risk “of a hybrid project, where the developer winds up as the landlord of a substantial number of units because of his inability to sell them.” Bohan, *A Lawyer Looks at Residential Condominiums, 7 Real Prop., Prob. Tr. J.* 7, 13 (1972) [hereinafter cited as Bohan]. See discussion in text at notes 175-79 supra with respect to the application of the Interstate Land Sales Full Disclosure Act to certain “phase” developments.

186 The unit owner’s decreasing interest in the common areas may not, in reality, be as severe as illustrated above. With each additional phase there may be some additional common areas added so that while the fractional interest is smaller, the area being fractioned is larger.

acter that may not be altered without the consent of all unit owners affected, expressed in an amended declaration. Obviously, provisions such as these will prevent the successive reduction of each unit owner's interest in common areas unless the affected unit owners agree, a contingency far too risky for the prudent condominium developer. Some suggest starting with the largest possible condominium contemplated under which, in the three phase example discussed above, each phase one unit owner would be given a 1/600th interest in the common areas at the start, although there are at that time only 200 unit owners. Then, if all the projected units are in fact built, the percentages will be correct. But this might not comply with the statute and would require amendment of documents to withdraw unsold units. This would not seem to be a satisfactory solution.

A better method is the so-called "chinese menu" approach. Here, "[t]he declaration sets forth in columns A, B, C, etc., what the percentage of interest of each unit will be in the common property" if one phase is built, if two phases are built, and so forth. The theory is that this sets forth the common interest as of the date of the declaration as is required by statute. Furthermore, since what is conveyed, ab initio, is a fluctuating interest as specifically set forth in the declaration, this interest has a permanent character and is not "altered" as the fluctuations specified in the declaration become effective. Consent of the unit owners would continue to be required if the percentages set forth in

flexibility in fixing the initial percentage of common elements attributable to each unit. N.Y. Sess. Laws [1974], ch. 1056, § 2(1) (McKinney). Four options are provided based upon proportionate value; approximate proportionate floor area; equal percentages; and floor space "subject to the location of such space and the additional factors of relative value to other space in the condominium, the uniqueness of the unit, the availability of common elements for exclusive or shared use, and the overall dimensions of the particular unit." Id. The latter option is the only one of the four that does not specify that it is set as of the date of filing the declaration, but this omission may have been inadvertent.


189 A power of attorney to give consent at a later date, or a consent itself given at the time the unit is purchased may be attempted. But death or incompetence of the unit owner may render the power of attorney ineffective, and one cannot feel completely confident that the courts will recognize the earlier consent as meeting the statutory requirements over the strenuous objections of a unit owner. With respect to powers of attorney, see Buck, Condominiums that Grow — Another View, Lawyers Title News, Mar.-Apr. 1972, at 11, 12-13 [hereinafter cited as Buck]; Krasnowiecki, Townhouse Condominiums Compared to Conventional Subdivision With Homes Association, 1 Real Estate L.J. 323, 357-58 (1973) [hereinafter cited as Krasnowiecki].


191 Rohan, supra note 188, at 14.
the declaration were to be changed. It now appears that title companies are willing to insure a condominium structured in this manner under certain circumstances.\textsuperscript{192}

Absent the “chinese menu” approach, the alternative seems to be to build a series of small separate condominiums with all the attendant expenses of separate prospectuses and filings. Sharing of common facilities would then be “worked out by means of contractual arrangements, easements, covenants and restrictions,”\textsuperscript{193} which may sound much simpler than it probably is.\textsuperscript{194} In some situations, developers may prefer to keep a large part of the common areas out of the condominium and hold title to these areas at least until completion of all phases and then, perhaps, convey the common areas to the unit owners, or in some cases where commercial facilities are involved, retain ownership indefinitely.\textsuperscript{195} In some cases, title to the common facilities may be held by a corporation, as discussed previously in this article. While the corporate approach would help to avoid the expanding condominium problem, it is probably not often employed because of the numerous other problems involved.

This is clearly another area where statutory clarification would be desirable. Steps in this direction are already being undertaken. Virginia, for example, recently revised its condominium enabling legislation to permit, under rather intricate statutory provisions, expansion, contraction, or conversion of condominium land.\textsuperscript{196} Similar legislation in other states would be most helpful.

\textsuperscript{192} See Outen, Condominiums That Can Grow, Lawyers Title News, Sept.-Oct. 1971, at 11. Outen states that the declaration should contain 1) a description of the land submitted to the statute and the land which may be added to the project in order to have definite and certain subject matter, id. at 11, 13; 2) the percentage interest in the common areas, the voting rights of old and new owners and the number and description of units that may be added, id. at 11, 14; 3) a specific time limitation on the developer’s option to expand the project (to avoid perpetuities problems), id. at 12; and 4) a limitation on the developer’s discretion as to the type and quality of future units, id. at 13. Outen, who is Assistant General Counsel for Lawyers Title Insurance Corporation, looks at the problem from a conveyancing standpoint, and does not deal with condominium legislation and regulations. Id. at 11. However, in conversations he has indicated that the language of the New York type statute discussed above would not deter the title company in a typical “chinese menu” situation. Nevertheless, he indicated that his company would hesitate to insure in New York because of objections raised by the Attorney General’s Office.

\textsuperscript{193} Second Generation Condominium Problems, supra note 190, at 88.

\textsuperscript{194} Buck, supra note 189, at 13.

\textsuperscript{195} But see PLI Transcript, supra note 32, at 358-59 (discussion by Professor Patrick J. Rohan and Lewis R. Kaster on the possibilities of the New York Attorney General approving a long-term lease to the unit owners of the facilities kept out of the condominium).

\textsuperscript{196} Va. Code Ann. §§ 55-79.39 to 79.103 (Supp. 1974). The new provisions with respect to the expanding condominiums are not without drafting problems. For example, while
The Expanding Liabilities

Every institution that decides to become a sponsor of a condominium should realize that the possibilities of liability are far greater than could ever be contemplated as a mortgagee. This section is primarily a caveat to that effect.

Already discussed has been the possibility of liability for violation of federal and state laws and regulations, including securities and blue sky laws\textsuperscript{197} and a builder's liability in tort for negligent construction of the condominium.\textsuperscript{198} A recent Florida case held that implied warranties of fitness and merchantability extend to the purchase of new condominiums from builders.\textsuperscript{199} This case points up the fact that the doctrine of \textit{caveat emptor} is taking quite a beating these days in connection with new home construction\textsuperscript{200} and that contractual liability may ensue from express warranties, implied warranties, and even, perhaps from some rather standard provisions in a contract of sale.\textsuperscript{201}

The point being made is that becoming a sponsor of a condominium is not something that should be undertaken lightly. If trust is placed in a developer-partner, it must be one in whom the institution has justifiable confidence.

Capital Improvements on Conversion and Semi-Leasehold Condominiums

While many condominiums are newly built, there may be a developing trend, at least in the housing area, toward condominium conversions.\textsuperscript{202} The institutional investor may receive offers from tenants

\textsuperscript{197} See text accompanying notes 141-84 supra.
\textsuperscript{198} See text accompanying notes 115-28 supra.
\textsuperscript{199} Gable v. Silver, 258 So. 2d 11 (Fla. Dist. Ct. App.), aff'd, 264 So. 2d 418 (1972).
\textsuperscript{200} The court said that there was no express disclaimer of implied warranties here. \textit{Id.} at 13-14. Had there been such a disclaimer, it is possible that the decision might have gone the other way.
\textsuperscript{201} Said the court: The general and still the majority rule is that implied warranties do not apply to realty. . . . This general rule is fast being eroded. At last count, fourteen states have adopted the modern rule, which extends implied warranties to realty. . . . Only three states who have recently considered this problem have declined to adopt the modern rule. \textit{Id.} at 14 (citation omitted).
for the purchase of apartment houses, housing developments, and even commercial buildings, as condominiums, or the institutional investor might sponsor such conversions itself. The prospective purchasers, however, may wish to make some capital improvements to the property, such as rewiring or air conditioning of an entire building or development. This section of the article will discuss the question of how prospective unit owners can get financing for such improvements under the present structure of the enabling legislation.

The condominium statutes generally severely restrict blanket mortgages on the condominium. For example, New York requires that all blanket mortgages at the time of first conveyance of the units to the unit owners must be satisfied of record; that banking organizations and insurance companies, inter alia, may not make mortgage loans on condominiums which are other than first mortgages or deeds of trust; and that liens of any nature are prohibited on the common elements of Parkchester, see note 168 supra, were announced. According to Assistant Attorney General David Clurman, this is probably the largest condominium conversion ever attempted. "If this succeeds . . . New York City might start going into condominiums in a big way." N.Y. Times, Dec. 15, 1972, at 49, col. 7. Harry Helmsley, who heads the syndicate operating Parkchester, stated that a successful conversion of Parkchester would produce "a revolution in New York real estate" in the next decade. Id. Whether or not the conversion is successful, the attempt has already produced, or given impetus to, restrictive legislation adopted in the 1974 session of the New York legislature. See N.Y. Sess. Laws [1974], ch. 1021, § 2 (McKinney), amending N.Y. Gen. Bus. Law § 352-c (McKinney 1968). This legislation presents serious difficulties to condominium conversions in New York, at least until its July 1, 1976 expiration date. In New York City, where Local Emergency Housing Rent Control ("emergency" from World War II) remains in effect for many apartments, tenants may not be evicted on conversion to condominiums or co-ops unless 35% of the existing tenants have agreed to purchase. New York City, N.Y., Admin. Code § YY.51-.60(c)(9) (1971). Parkchester had been able to avoid obtaining the required 35% resident approval for conversion of at least the first quadrant by agreeing to permit all rent controlled tenants to remain in possession indefinitely. The new law would prohibit the attorney general from approving any plan which does not provide that consent of at least 35% of the tenants must be obtained before the plan may be declared effective. N.Y. Sess. Laws [1974], ch. 1021, § 2 (McKinney). In addition, the new legislation declares, inter alia, that if the plan is not declared effective generally within one year from filing, it is deemed abandoned and no new plan may be submitted within 18 months from the date of abandonment; no eviction proceedings may be brought against residents for two years, even if a lease has expired, unless the tenant has failed to pay rent or the like; and there must not have been an "excess number of long term vacancies" on the date of submission. Id.

When the institution is a mortgagee in a building that is being converted to a condominium, it will be necessary to release the lien of the mortgage before the units are sold. The mortgagee may be asked first to amend its mortgage from one describing the entire property to one describing each unit and its common interest, and then to release each unit as it is sold. The mortgagee may also be asked to join in the declaration, which may mean that if the condominium doesn't go through, the mortgagee on foreclosure will own condominium units. See Krasnowiecki, supra note 189, at 335-36, for a discussion of the construction mortgagee's position where the condominium is not consummated.

204 N.Y. Real Prop. Law § 339-ff(b) (McKinney 1968).
“except with the unanimous consent of the unit owners.”206 While New York seems to have one of the more restrictive statutes207 in this connection, many other state enabling laws would effectively limit the ability of the prospective unit owners to finance substantial capital improvements in a condominium.

On the other hand, there would seem to be a real need to protect the unit owner against the dangers of blanket mortgages which can cut off the estate of the unit owner for reasons other than acts or defaults of his own.208 Nevertheless, a legislative solution which would give reasonable protection to the unit owner, but permit financing for needed improvements, would seem possible. With respect to capital improvements needed at the time of conversion, it is suggested that the statute authorize a limited blanket mortgage on the condominium for capital improvements provided that the amount of the mortgage and a complete description of the proposed capital improvements are contained in the declaration. It would also be necessary in many states to amend the legislation to provide that such mortgages may be subordinate to the individual unit mortgages,209 and that such subordinate mortgages would be a legal investment for at least the institution that owned the property prior to the condominiumization and sold it to the association.

This suggested amendment would not, of course, solve the problem of financing capital improvements which become necessary after condominiumization. This is a problem not only for conversions but for every condominium. To facilitate such financing, the statute might be amended to permit blanket mortgages upon a vote of say, 80 percent of the unit owners with an overall limitation on the amount of such mortgages expressed in terms of actual dollars or a percentage of the cost or assessed valuation of the condominium.

An alternative solution upon conversion might be for the institution to create a semi-leasehold condominium through the use of a sale-

206 Id. §39-L(1).
207 Many states, for example, do not specifically prohibit blanket mortgages and New Jersey specifically authorizes blanket first mortgages in the following language: “[I]f the master deed or by-laws so permit, the entire condominium property, or some or all of the units included therein . . . may be subject to a single or blanket mortgage constituting a first lien thereon. . . .” N.J. STAT. ANN. § 46:8B-23 (Supp. 1973). See also MICH. STAT. ANN. § 26.5018 (Supp. 1973). Furthermore, other states do not limit financial institutions to first liens “notwithstanding any other provision of law.”
208 One of the advantages often cited for the condominium over the cooperative from the unit owner's point of view is the absence of the large blanket mortgage which makes the cooperative holder so dependent upon the solvency of others. See 4A R. POWELL, THE LAW OF REAL PROPERTY § 653.10 (rev. ed. P. Rohan 1972).
209 See, e.g., N.J. STAT. ANN. § 46:8B-23 (Supp. 1973) (blanket mortgages authorized provided they are first liens).
leaseback of the land. Under this procedure, the land would be sold by
the purchasing association to the institution prior to conveyances of the
individual units, or where the institution is the vendor, the purchasing
association would buy only the buildings. The institution would lease
the land to the association and the association would convey to the pros-
pective unit owners a fee interest in their portion of the buildings and
assign to them a leasehold interest in the land. The purchase price
of the fee interest in the land (if the fee is sold to the institution) or
the value attributable to the land (if the association purchases only the
buildings) would be used to pay for the capital improvements, thus
increasing the value of the unit owners' interests so that the conveyance
of the fee should not reduce the possible mortgage available to the unit
owners. Such a mortgage would be a combination leasehold-fee mort-
gage. Probably, the individual unit mortgage would provide for a
"floor" loan of a lesser amount until the improvements are completed,
with payment of the additional sums upon such completion.

One difficulty with the use of the sale-leaseback technique is that
the unit owners would probably not be able to deduct the real estate
taxes on the land, title to which is in the institution. Another prob-
lem is that, at least in several states, leasehold condominiums may not
be legal. Many of the statutes do not mention leaseholds and some may
effectively prohibit them, expressly or impliedly. Except in the case
of nonresidential condominiums most authorities conclude that lease-
hold condominiums would not be permitted in New York, relying on

210 Such a sale-leaseback after conversion would be difficult, because of the existence
of first unit mortgage liens on the units and the unit owner's undivided interest in the
common areas. Either the unit mortgages would have to be subordinated, or the institu-
tion would have to take title subject to the unit mortgages, an unlikely prospect.

211 As an additional protection to the unit owner, it has been suggested in con-
nection with the leasehold condominium that each unit owner's lease run directly between
the landowner and the unit owner so that there is no one blanket lease of the condo-
minium which would be subject to defeasance occasioned by acts or failures beyond
the control of the individual unit owner. See D. CLURMAN & E. HEBARD, CONDOMINIUMS
AND COOPERATIVES 151 (1970) [hereinafter cited as CLURMAN & HEBARD].

212 See note 59 supra; CLURMAN & HEBARD, supra note 211, at 148-49.

213 CLURMAN & HEBARD, supra note 211, at 147. Some of the possible abuses of the
leasehold condominium are set forth in Watch Out for Florida Condominiums!, DUN'S
June 1973, at 58, 61-62. See Florida's recent amendments regulating leasehold condomi-

214 See N.Y. Sess. Laws [1974], ch. 1056, § 1 (McKinney), which amends the definition
of "property" in N.Y. REAL PROP. LAW § 339-c(11) (McKinney 1968) to include "in the
case of a condominium devoted exclusively to non-residential purposes, [land, building
and other improvements] held under a lease or sublease, or separate unit lease or sub-
lease, the unexpired term or terms of which on the date of recording of the declaration
shall not be less than thirty years. . . ." The New Jersey Legislature has recently authorized
the language of the New York enabling legislation which defines "unit owner" as "the person or persons owning a unit in fee simple absolute." Of course, what is being suggested here is not a pure leasehold condominium, and it could be argued that under the semi-leasehold, the New York requirement that the unit be owned in fee simple absolute is met. It may be significant that the FHA Model Act defines "apartment owner" (the Act's equivalent of "unit owner") as one owning an apartment "in fee simple absolute and an undivided interest in the fee simple estate of the common areas and facilities. . . ."

Notwithstanding the foregoing, a more cautious approach in those states where there is doubt about whether leasehold condominiums are permitted, would be to attempt to separate out from the condominium some of the common elements to which a measure of value may be attributed, such as recreational facilities, swimming pools, etc., and lease these to the condominium owners, leaving the condominium itself owned in fee simple absolute. Even here, however, there are problems, such as whether any resulting break in the contiguity of condominium property is permitted; whether rent payable under property leased to the condominium is a common charge subject to being enforced by the association's lien; and whether local regulatory agencies will permit the long term lease. Also, as far as certain institutions are concerned, state regulatory statutes may not permit ownership of land used primarily for recreational purposes.

The real solution to the problem of condominium improvements

215 N.Y. REAL PROP. LAW § 339-e(15) (McKinney 1968). See CLURMAN & HEBARD, supra note 211, at 147, where New York is listed among those states which expressly or implicitly bar leasehold residential condominiums, and Fegan, supra note 83, at 271, where the author states: "Leasehold condominiums are not permitted in New York and Illinois and in many other states."

216 But see note 57 supra.

217 FHA Model Act supra note 12, § 2(b) (emphasis added).


219 Some statutes limit the lien for common charges to expenses arising out of common elements. See, e.g., CAL. CIV. CODE §§ 1355(b)(3), (4), (5), and (e) (Supp. 1972). See also Krasnowiecki, supra note 89, at 360-61.


221 See, e.g., N.Y. INS. LAW § 81(7)(h) (McKinney Supp. 1972), which was recently amended, N.Y. SESS. LAWS [1972], ch. 743, § 2 (McKinney), to delete the clause prohibiting acquisition of real property for the production of income if such property was "to be used primarily for agricultural, horticultural, ranch, mining, recreational, amusement or club purposes. . . ."
is statutory amendment, which as condominiums grow older, will be needed more and more.

**Institutional Investor as Condominium Owner**

We have come to what is perhaps the most speculative portion of this article. Normally, one would not expect many institutional investors to be owners of condominium units except as a result of foreclosure of mortgages. Yet many condominium enabling statutes are applicable to commercial and industrial, as well as residential developments, and one can foresee a dramatic increase in the use of the condominium for industrial and commercial development in the future. This portion of the article will discuss a few areas where the institutional investor may find condominium ownership more advantageous than conventional fee or leasehold ownership.

**Company Offices**

If an institution wishes to open an office not large enough to occupy an entire high-rise office building, it will normally lease the space it needs, with all of the lack of flexibility and freedom of use, and with none of the possibility of appreciation associated with real estate ownership. If the institution does not wish to lease space, it may construct its own building and become landlord of the space it does not use or it may construct a smaller building, probably not in the high-rent district, for its own use.

While any of the above alternatives may be the most desirable approach for the institution to take depending on the particular facts and circumstances, the advent of the commercial condominium affords the institutional investor yet another alternative, under which it can have the full advantage of real estate ownership, without owning more space than it might foreseeably use, and do so in a high-rise building in the commercial center of town. Other corporations have in growing numbers purchased condominium office space as shown by a recent survey in *The Condominium Report*, which describes "innovative projects".

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222 Many states and the FHA Model Act use the term "apartment" instead of "unit." In such states, unless the definition of "apartment" encompasses industrial and commercial purposes, condominiums may be limited to residential buildings. For a discussion of this problem, see 1 ROHAN & RESKIN § 5.01[2]. Nevertheless, "[i]t is anticipated by many that commercial condominium development will account for at least as much if not more of the volume of condominium development than will residential condominium development." Id. at 5.05. See generally D. CLURMAN, THE BUSINESS CONDOMINIUM (1973) [hereinafter cited as CLURMAN], for a thorough analysis of the structuring of this "new form of business property ownership."

223 1 CONDOMINIUM REP., June 1973, at 5-8.
[that] have begun to make their appearance in ever increasing numbers covering multi-use, office building, industrial and shopping center condominiums, and conversions of existing structures to commercial condominium status. The list is impressive.

Condominiums vs. the Ground Lease

Where an owner of real estate wishes to retain title for any number of reasons, and to lease for long term income, it is fairly clear that condominiumization would not achieve these objectives except possibly through a leasehold condominium. This is also true where the tenant is not interested in owning real estate but would rather have a leasehold interest. In other areas, however, the condominium may be a far more preferable alternative to the long-term ground lease.

One such area involves a situation such as that which existed when the so-called "Park Avenue Properties" were developed. In 1913, New York City, as an antipollution measure, required that the huge cut, through which ran New York Central trains to and from Grand Central Station, be covered. The railroad complied and built platforms over the open railroad tracks. The next step was to arrange for the development of these platforms with the construction of buildings along what is now part of Park Avenue in New York City. The railroad needed the subsurface for its tracks and equipment. The answer seemed to be to lease out the platforms to people who would build buildings on them. Unfortunately, however, the railroad's blanket mortgage did not permit subordination to a leasehold. It did, however, permit the trustees to release from the lien of the mortgage such land as had been conveyed by the railroad as a freehold estate. Thus was born the "grant of term" under which the railroad conveyed an estate for a term of years to a subsidiary corporation free of the mortgage. After the release, the mortgage encumbered the railroad's remainder interest only, and the subsidiary was free to enter into ground leases with developers.

Today, the merged Penn Central Railroad is in reorganization, and

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224 Id. at 5.
225 For example, long-term appreciation, and, where a building is involved, depreciation for tax purposes.
the trustees have indicated that they may seek a declaratory judgment as to their right to disaffirm at least some of the leases.\textsuperscript{229} Institutional investors are involved in the Park Avenue properties as both "ground" and "sandwich" lessees and as leasehold mortgagees. While it would seem that the conveyance of an estate for a term of years is no less a conveyance than a conveyance of a fee, and no more subject to disaffirmance,\textsuperscript{230} the specter of a disaffirmance has cast a pall over leasehold investment and leasehold mortgaging throughout the country.\textsuperscript{231}

Had a condominium law been in effect when the Park Avenue properties were created, the question faced today with respect to possible disaffirmance might possibly have been avoided. Under such legislation, a condominium might have been established under which the railroad owned the tracks, with the developer (or group of developers) owning the property above the surface in one or more condominium "units," with all parties having undivided interests in certain common areas.\textsuperscript{232}

This would probably have met the release requirements of the railroad's blanket mortgage, but, of course, the railroad might not have been willing to give up the prospect of the long-term net income. Nevertheless, it would seem that whenever the leasehold is employed and one or more of the parties must have the use of a portion of the real property, there is a possibility, absent business or other considerations to the contrary, that the condominium may be a more preferable form of ownership of interests in the real estate.

The question that follows is, of course, can the condominium be employed in most of the long-term leasehold situations that have become common, and thus eliminate the specter of disaffirmance? The answer, unfortunately, is no under most of the situations as we now know them. For example, in the usual sale-leaseback, where the owner of the fee leases the entire land to a ground lessee, there may be no method of establishing a condominium because the real property is not being divided. Rather, the title to the property is being divided into


\textsuperscript{231} \textit{Id.} at 1435 n.161.

\textsuperscript{232} It is possible that a "condominium-like" conveyance of air space could have been worked out without a condominium statute even then. \textit{See} Becker, \textit{supra} note 228, for a discussion of such a conveyance where "the purchasers were distinctly pioneering in this field." \textit{Id.} at 10. \textit{See also} Krasnowiecki, \textit{supra} note 189, at 324.
various types of estates — normally, a reversion and a leasehold, but there may be many layers of leasehold interests. Nevertheless, a condominium may be used in some circumstances where the sale-leaseback has previously been employed. The advantages of the “sale-condoback” are discussed by New York Assistant Attorney General David Clurman in his book The Business Condominium. Under this arrangement, the owner will contract to sell his property on condition that part of the same property is deeded back in condominium unit form. Thus “an owner can retain a valuable portion of real estate as an owner while cashing in on a substantial selling price for the rest of the property.”

Other Possibilities

Notwithstanding the apparent limitations on the use of the condominium in some of the conventional ground lease situations, there are other possibilities for the use of condominiums, sometimes along with ground leases. For example, a group can acquire a parcel or parcels of property with a view to condominiumization, and each may operate their portion of the real estate, or ground lease it to a sandwich or operating lessee. In this way, it is possible to conceive of the future development of vast acreages of commercial as well as residential condominiums, with each developer owning his portion, but with the entire condominium operated by an association, with tenants of the condominium owners entitled to use facilities common to the “unit” owners.

The possibilities may be endless. There is no doubt that condominium ownership offers a flexibility to the development and use of land undreamed of not many years ago. In such development, there unquestionably will be an active and important place for the institutional investor.

Conclusion

The phenomenal condominium boom has been heard throughout the land. An institutional investor cannot help but become involved, certainly as mortgagee, possibly as sponsor, and, under some circumstances, perhaps as owner. This article has looked again at the condominium picture, eleven years after William Kerr’s preview, in an

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233 In many of our large cities, the ground lease has been used to divide a fee estate and the investment therein among several participants. Office buildings are often structured in layers of ground leases, sandwich leases and operating leases. For an example of such layering, see Creedon & Zinman, supra note 230, at 1391 n.3.

234 Clurman, supra note 222, ch. IV.

235 Id. at 55

236 This may be a fee interest, or where permitted by the applicable condominium enabling legislation, a leasehold interest.
attempt to highlight some of the current problems faced by, and opportunities available to, life insurance companies and other institutions in condominium investment.

Certainly all the problems have not been explored and, due to limitations of space and scope, many of those that have been covered have been touched on only lightly. In addition, as institutional involvement in condominium investment increases, many new and difficult problems, as well as many new and fascinating opportunities, unknown today, will undoubtedly appear. So perhaps "conclusion" is the wrong title for this section of the article. The condominium journey from the legal as well as business standpoint may be just beginning in this country. And as we move into these uncharted waters, we see the horizon constantly receding before us. Nevertheless, although conclusions may be difficult to reach, a few sailing directions can be gathered from this article.

1. There is much need for a comprehensive revision of condominium enabling legislation on a national and uniform basis. If a uniform condominium statute were to be drafted and adopted in the several states, it could clarify and eliminate many of the problems faced today by the condominium mortgagee, sponsor, and unit owner. Fortunately, the National Conference of Commissioners on Uniform State Laws' Special Committee on Uniform Land Transactions Code has begun to consider the drafting of such a uniform condominium act as Article VII of its proposed Code. It is important that the statute not be simply the lowest common denominator of existing condominium legislation. If the drafters will deal directly with the current problems such as limiting tort liability, providing for a comprehensive, sensible insurance program, and facilitating the development of the expanding condominium and the financing of capital improvements, to mention only a few, the uniform act can constitute a significant contribution to the economic development of the nation and the standard of life of its inhabitants.

2. Until clarifying legislation is enacted, life insurance companies and other institutions must guard against becoming so caught up in the condominium explosion that the problems and risks are ignored. With proper caution, careful study of the transactions, and close control over decisions which can affect profits, return and liability, there is no doubt that a great role may be played by the institutional lenders in condominium investment and development.